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The Evolution of the Supreme Court's Rule 10b-5 Jurisprudence: Protecting Fraud at the Expense of Investors

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* Professor of Law, Loyola University Chicago. I would again like to express my appreciation for his many helpful comments to David Ruder, Professor of Law at Northwestern University and Former Chairman, Securities and Exchange Commission. Prof. Ruder pointed out that, with class actions, an expansive approach to Rule 10 b-5 could potentially impose ruinous liability on an issuer. I concur. But *Central Bank* and its progeny can create a "what, me worry" attitude. The best way to avoid liability is to tell the truth. Unfortunately, in business, as in politics, truthfulness is sometimes a forgotten virtue.

The Evolution of the Supreme Court's Rule 10b-5 Jurisprudence:

Protecting Fraud at the Expense of Investors

This past year, the Supreme Court, in Janus Capital Group, Inc. v. First Derivative Traders,[1] decided the third in a trilogy of decisions that are unique in their questionable jurisprudence and their objective goal of protecting fraud. Since the Supreme Court ventured into the Rule 10b-5 domain in 1969, it has handed down several decisions that can be grouped into a series of trilogies.

The first trilogy was a "liberal" one that expanded the scope of Rule 10b-5,[2] while the second trilogy was a conservative one that put the brakes on the expansion of Rule 10b-5.[3] This latter trilogy embodied sound policy and thoughtful jurisprudence, although *Blue Chip Stamps*[4] did not reflect judicial restraint—at this point a bellweather of conservative judicial philosophy. But then came two trilogies, supposedly conservative, that were characterized by sloppy reasoning and an outcome-determinative approach to judicial decision making. The third trilogy dealt with insider trading[5] and the fourth, and current, trilogy with the potential liability of those who might be characterized as "collateral participants" in fraud.[6] Sadly, these latter two trilogies had the effect of insulating corporate corruption from liability and undermining the investor protection that was the goal of the securities acts.

The first decision in the fourth trilogy, Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.[7], eliminated secondary liability for aiding and abetting under the securities laws. Congress responded by reinstating aiding and abetting liability in enforcement actions brought by the Securities Exchange Commission ("SEC").[8] The second decision, Stoneridge

[1] 131 S.Ct. 2296 (2011).
[2] *See infra* Part I.A(b).
[3] *See infra* Part I.B.
[4] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
[5] *See infra* Part I.C.
[6] *See infra* Part II.
[7] 511 U.S. 164 (1994).
[8] Private Sec. Litig. Reform Act of 1995, Pub. L. No. 104-67, 1995 U.S.C.C.A.N. (109 Stat.) 737 (1995).

Investment Partners v. Scientific-Atlanta, Inc.,[9] though arguably involving primary liability, rejected a cause of action against those who conspired with their customer to inflate the customer's earnings. Supposedly the Supreme Court was constrained by the *Central Bank* decision. The third and current decision, *Janus Capital*, insulated an asset management firm and its investment advisor subsidiary from liability for misrepresentations made by a mutual fund it sponsored. The court's ill-reasoned analysis as to who "makes" a misrepresentation has far-reaching implications, and the logic of its decision could insulate all corporate management, other than directors, from any liability for fraudulent representations the corporation makes affecting securities markets.

Part I of this article first traces the evolution of Rule 10b-5 from its origin and development in the lower courts until the Supreme Court's initial venture into the Rule 10b-5 thicket, in which the court facilitated the expansion of Rule 10b-5 litigation, arguably beyond reasonable boundaries.

Part I then reviews the second trilogy in which the court, moving in a conservative direction after appointments by President Nixon, placed a series of constraints upon the ability to bring a Rule10b-5 action, employing a well-reasoned perspective that took into account the other provisions of the securities laws. Part I then analyzes the third trilogy which involved, not putting a brake upon unwarranted expansion of Rule 10b-5, but rather undercutting the essential purposes of the securities laws to provide a fair playing field for investors - and regressed the analysis of securities litigation to a common-law perspective, even though the securities were enacted because the common law was inadequate to deal with securities fraud.

Part II of the article focuses upon the liability of what are arguably collateral participants, that is, persons who are not the primary wrongdoer but rather assist or conspire with the primary wrongdoer. This is a critical area since the primary wrongdoer, by the time the fraud is uncovered, often is insolvent or otherwise unable to make whole the investors injured by the fraud. In addition, collateral participants are often "gatekeepers" upon whom the public relies to ensure that issuers are responsible and accountable.

The tragedy of the decisions comprising the fourth trilogy is that the wrongdoing is unquestioned; yet the Supreme Court opted to let the wrongdoers go unpunished and extended similar protection to subsequent generations of wrongdoers. Part II first examines the unparalleled judicial activism reflected in the *Central Bank* decision and how the Court twisted well-settled principles of law in an outcome-determinative mode of judicial decision making. *Central Bank* appeared to leave the door ajar when, arguably, those assisting the primary wrongdoer were so directly involved in the fraud that they could be considered primary wrongdoers themselves. But, in *Stoneridge Investment Partners*, an unwarranted extension of

[9] 552 U.S. 148 (2008).

Central Bank, the Court again twisted logic in holding that a conspiracy with suppliers to inflate earnings did not impact investors.

Finally, Part II analyzes the impact of *Janus Capital*. Superficially, the decision involves a limited issue: the responsibility of an asset manager for misrepresentations made by its captive mutual fund. However, by markedly narrowing the concept of who "makes" a misrepresentation, the decision could have far-reaching, untoward consequences. For example, the District Court in the Enron litigation found that the attorneys for the company, who knowingly drafted false disclosure documents for Enron, could be liable for "making" a misrepresentation. This analysis would now be foreclosed by the *Janus Capital* decision.

The Conclusion asserts that the Supreme Court was fully aware of the wrongdoing involved and the impact of its decisions. Thus, the conclusion is inescapable that the Supreme Court has chosen to facilitate corporate fraud at the expense of the investing public.

I. The First Three Trilogies: A Brief History of the Evolution of Rule 10b-5

A. The Growth of a Little Acorn into a Massive Oak Tree, and the First "Liberal" Trilogy

a) The Early History of Rule 10b-5 and the Judicial Expansion

Rule 10b-5 was promulgated in 1940[10] pursuant to section 10 of the 1934 Securities Exchange Act.[11] By its terms, it defines illegal manipulative or deceptive conduct and could be the basis for a Securities & Exchange Commission ("SEC") enforcement action[12] or criminal prosecution by U.S. attorneys.[13] It was not until 1946, in *Kardon v. National Gypsum*,[14] that a federal court implied a private course of action based upon Rule 10b-5. What is striking about the opinion is its brevity and curt analysis. Based upon the analogy to a "statutory tort,"[15] the *Kardon* court accepted as basically self-evident the judicial principle that a rule defining illegality could establish a duty, the breach of which could give rise to a civil cause of action.

After the *Kardon* decision, litigation premised upon Rule 10b-5 figuratively exploded. While courts frequently struggled to find deception,[16] many of these cases involved conduct that

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[10] SEC Rule 10b-5, 17 C.F.R. § 240.10b–5 (2011).
[11] 15 U.S.C. § 78j (2011).
[12] *Id.*
[13] *Id.*
[14] 69 F. Supp. 512 (E.D. Pa. 1946).
[15] *Id.* at 513-14.
[16] *See, e.g.*, Santa Fe Indus. v. William Green, 430 U.S. 462 (1977) (holding that deception is required for a violation of Rule 10b-5); Madison Consultants v. Fed. Deposit Ins. Corp., 710 F.2d 57, 62 (2d Cir. 1983) (alleged wrongful removal of a restrictive legend on a stock issuance was not a cause of action under Rule 10b-5 because plaintiffs

could be characterized as a breach of fiduciary duty.[17] Thus some commentators questioned whether there was developing a federal law of corporations.[18]

The apogee of the development of Rule 10b-5 occurred in 1968 in the Texas Gulf Sulphur litigation. In an enforcement action, *SEC v. Texas Gulf Sulphur*, the Second Circuit examined the conduct surrounding the discovery by Texas Gulf Sulphur of a rich ore deposit in Timmins, Canada.[19] "Act I" encompassed the period from the drilling of a core in November, 1962 until April 1963.[20] During this period, corporate employees and directors purchased Texas Gulf Sulphur stock on the open market.[21] "Act II" began in early April 1963, when rumors that the ore strike was extraordinary began circulating; in response, the company issued what has been characterized either as a "gloomy" or a "misleading" press release on April 12 and four days later, announced the extraordinary nature of the find.[22]

With regard to Act I, the Second Circuit determined that employees, even low level employees, who purchased stock, were "insiders" who could not trade on "inside information," namely material non-public information,[23] but rather had a duty to "disclose or abstain."[24] In Act, II, in determining that the company was liable for the misleading press release, the court essentially employed a negligence standard.[25] And, in defining materiality, the court vacillated between information that a reasonable investor "might"[26] consider important versus "would"[27] consider important. While the case was an enforcement action, it spawned a series of private damage actions.[28]

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alleged no manipulation or deception); Kademian v. Ladish Co., 792 F.2d 614, 622 (7th Cir. 1986) (after extensive analysis of whether defendants deceived the plaintiffs, the court affirmed the dismissal of the 10b-5 claims for lack of manipulation or deception).

[17] *See, e.g.*, Slavin v. Germantown Fire Ins. Co., 174 F.2d 799, 814 (3d Cir. 1949) (stating that the court need not find a breach of a fiduciary duty to find liability under federal securities laws, but such a breach can be sufficient in showing a violation); Rosenfeld v. Black, 445 F.2d 1337 (2nd Cir. 1971) (holding that an investment advisor corporation that realized profits in connection with the appointment of a new advisor upon its recommendation violated its fiduciary duty, thereby violating the Investment Company Act); and Schein v. Chasen, 478 F.2d 817, 823 (2d Cir. 1973) (stating that while a breach of fiduciary duty usually leads to recourse through state laws, such a breach can also lead to a federal cause of action under Rule 10b-5).

[18] *See, e.g.*, Arthur Fleischer, Jr., *Federal Corporation Law: An Assessment* 78.6 HARV. L. REV. 1146 (1965); Stanley A. Kaplan, *Corporation Law and Securities Regulation*, 18 Bus. Law. 868 (1963); and A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons From History*, 106 COLUM. L. REV. 1793 (2006).

[19] Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

[20] *Id.* at 843-45.

[21] *Id.*

[22] *Id.* at 845-46.

[23] *Id.* at 848.

[24] *Id.*

[25] Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 862-863 (2d Cir. 1968). This position was reversed in *Ernst, discussed infra* text at note 101.

[26] *Id.* at 860.

[27] *Id.* at 863. The Supreme Court, in TSC Industries. Inc. v. Northway, Inc., 426 U.S. 438 (1976), adopted the would/probability standard.

[28] *See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (holding insiders liable directly to plaintiffs that purchased stock on the open market without knowledge of the material inside

Texas Gulf Sulphur was foreshadowed by an SEC decision authored by former Columbia Law Professor William Cary, and then SEC Chairman, *In re Cady, Roberts & Co.*[29] That case was a "bad news" situation: Curtiss Wright's board of directors had decided to cut the dividend. In such a situation, someone with foreknowledge might seek to sell Curtiss Wright stock. A board member, thinking that the information had earlier been disseminated to the public by the corporate secretary,[30] telephoned a fellow partner at Cady Roberts who then sold the stock.

The Commission's opinion is significant in several respects. First, the partner back at the office (the "tippee") had no connection to Curtiss Wright. Second, the "tipper," the director, did not know that dissemination of the information had been delayed and thus did not "sin," a fact that the Supreme Court, in the *Dirks* case, did not appreciate.[31] Most importantly, since this was a bad news situation, the insider would be selling to a buyer who very likely was not a shareholder.[32] Contrast this with a "good news" situation in which the insider would seek to buy stock: the only person from whom the insider could buy stock would be a shareholder to whom a corporate insider arguably would owe a fiduciary duty.[33] The defendant argued that no duty was owed to a non-shareholder, but the Commission made short shrift of this argument by asserting that the securities laws were enacted because the common law was inadequate to protect investors.[34] Thus, the absence of a common law duty was irrelevant to whether there was a violation of the securities laws - a proposition that the Supreme Court, in *Chiarella*, declined to follow.[35]

(b) The First Trilogy: The Supreme Courts Belated Role in Expanding the Scope of Rule 10b-5.

(1) *National Securities:* The Supreme Court's Initial Foray into Rule 10b-5.

Over twenty years passed between the judicial recognition of a private cause of action under Rule 10b-5 in *Kardon* and the Supreme Court's initial consideration of this cause of action in SEC v. National Securities, Inc.[36] As the Court noted, "[a]lthough § 10(b)

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information); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) (allowing civil liability in a class action based on material misstatements and omissions contained in a registration statement).

[29] 40 S.E.C. 907 (1961)(*discussed infra* text at notes 154, 186).

[30] *Id*. at 908.

[31] *See* Dirks v. S.E.C., 463 U.S. 646 (1983) (holding that the "tippee" only sins if the "tipper"sinned, meaning the defendant who received inside information from an insider who did not personally benefit from the disclosure was not liable under Rule 10b-5).

[32] In "bad news" cases, the insider knows about some impending harm to the company, meaning the stock price will fall in the future. Here, the insider sells stock, and the buyer of that stock generally did not already own stock in that company. While a current stockholder can always buy more stock, it will often be someone without any current ownership of the company.

[33] *But see* Goodwin v. Agassiz, 283 Mass. 358 (1933) (holding, in a "good news" case, that directors had no duty to disclose their identity, or the good news, when buying shares from a current stockholder).

[34] 40 S.E.C. at 911.

[35] Chiarella v. U. S., 445 U.S. 222 (1980).

[36] 393 U.S. 453 (1969).

and Rule 10b-5 may well be the most litigated provisions in the federal securities laws, this is the first time this Court has found it necessary to interpret them."[37] The *National Securities* Court then asserted a caution that the Court as constituted subsequent to 1980 should have heeded: "The questions presented are narrow ones. They arise in an area where glib generalizations and unthinking abstractions are major occupational hazards."[38]

The primary issue in this case was whether the approval of a merger by the Arizona Director of Insurance precluded an action by the SEC to set aside the merger on the ground that its approval had been procured by a misleading proxy statement. The defendants argued that such action by the SEC would supersede state law regulating the business of insurance in violation of the McCarran-Ferguson Act.[39] The Court concluded that "[t]he paramount federal interest in protecting shareholders is in this situation perfectly compatible with the paramount state interest in protecting policy holders.[40]

Judgment on the pleadings in favor of defendants had been affirmed by the Ninth Circuit on the basis that McCanon-Ferguson Act barred the SEC action.[41] However, defendants had also argued below that a merger did not constitute a "purchase or sale" under Rule 10b-5 and that Rule 10b-5 would not apply to misrepresentations in connection with a proxy notification.[42] While these issues were not directly before the Court, it "reached" to provide guidance to the trial court on remand.

The court made short shrift of both arguments. With respect to the purchase or sale issue, the Court rejected the "no sale" argument premised upon the former Rule 133[43] and determined that a merger did constitute a sale for purpose of Rule 10b-5. The court stated:

> Whatever the terms 'purchase' and 'sale' may mean in other contexts, here an alleged deception has affected individual shareholders' decisions in a way not at all unlike that involved in a typical cash sale or share exchange. The broad antifraud purposes

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[37] *Id.* at 465.
[38] *Id.*
[39] 15 USCA §1012(b): "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance."
[40] 393 U.S. at 463. The Court also stated: "The gravamen of the complaint was the misrepresentation, not the merger. The merger became relevant only insofar as it was necessary to attack it in order to undo the harm caused by the alleged deception. Presumably, full disclosure would have avoided the particular Rule 10b-5 violations alleged in the complaint. Nevertheless, respondents contend that any attempt to interfere with a merger approved by state insurance officials would 'invalidate, impair, or supersede' the state insurance laws made paramount by the McCarran-Ferguson Act. We cannot accept this overly broad restriction on federal power." *Id.*
[41] *Id.* at 456.
[42] *Id.* at 464-465.
[43] Former Rule 133 provided that certain transactions such as mergers, did not involve a "sale" under the 1933 Act and thus the stock issued in the transaction did not need to be registered with the SEC prior to sale. 17 CFR§ 230.133 (1968).

of the statute and the rule would clearly be furthered by their application to this type of situation. Therefore we conclude that Producers' shareholders 'purchased' shares in the new company by exchanging them for their old stock.[44]

At this stage, the Supreme Court was not only comfortable with the development of Rule 10b-5 by the lower courts but also focused upon an expansive interpretation of Rule 10b-5 to further the anti-fraud purposes of the securities acts.

The Court also determined that the argument that Rule 10b-5 did not cover misrepresentations in proxy material could "be dismissed rather quickly."[45] Even though an insurance company might be exempt from federal proxy regulation, "Congress may well have concluded that the Commissions general antifraud powers over purchases and sales of securities should continue to apply to insurance securities."[46] The approach of the Court suggests a presumption in favor of expanding the coverage of Rule 10b-5 to prevent fraud, rather than restricting the scope of Rule 10b-5 to facilitate fraud.

2. *Bankers Life:* The Apogee of Supreme Court Expansion of Rule 10b-5

Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company was a very short and superficial opinion dealing with a very complicated set of facts.[47] In effect, a crook, Begole, purchased all the stock of Manhattan Casualty Co. for $5 million. Begole and other conspirators then caused Manhattan to sell U.S. Treasury bonds for approximately $5 million and appropriated the proceeds to pay Bankers Life the $5 purchase price. Suit was brought by plaintiff as liquidator of the assets of Manhattan.

The Second Circuit, in affirming the dismissal, stated that "no investor [was] injured" and that "the purity of the security transactions and the purity of the trading process were unsullied."[48] The facts would seem to support the Second Circuit's reasoning. Bankers Life sold the shares of its subsidiary for $5 million. In fact, Bankers Life received $5 million, apparently what the shares were worth. Therefore, there was no fraud in the purchase of the Manhattan stock. With respect to the sale of bonds by Manhattan, apparently the bonds were worth what the buyer of the bonds paid. Thus the buyer of the bonds was not defrauded. Moreover, since the bonds were worth what Manhattan sold them for, Manhattan was not defrauded in the bond transaction *itself*. What happened was that the proceeds of the sale, instead of being deposited in Manhattan's bank account, were misappropriated by the crooks.

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[44] 393 U.S. at 467.
[45] *Id.* at 468.
[46] *Id.* at 468-469.
[47] 404 U.S. 6 (1971).
[48] Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 430 F.2d 355, 361 (2d Cir. 1970) rev'd, 404 U.S. 6, (1971)

The way this became a securities case is that the asset that was sold was a financial asset, namely, Treasury bonds. If, instead of being a Treasury bond, the circumstances were the same except that the company whose stock was purchased was a construction company and the asset sold was a massive crane, this is no way could be conjured to be a securities case.

In the case at bar, as the Second Circuit court observed, no investor was injured. This was a situation in which crooks embezzled from a company they owned. The company was bankrupt and the state agency sought to recover the embezzled funds. No one was deceived about the value of any security. Each party to both of the securities transactions received the price that each sought. It is such a real stretch to treat this as a securities case.

The Supreme Court acknowledged that, "[t]o be sure, the full market price was paid for those bonds."[49] But the Court added: "but the Seller was duped into believing that it, the seller, would receive the proceeds."[50] The Court, understandably, was concerned that there was an act "which operated as a 'fraud or deceit' on Manhattan."[51] But, embezzling the proceeds of the sale of a crane would also be a fraud or deceit. But, it is not a securities fraud. This is a suit on behalf of creditors of a corporation to recover funds embezzled by the owner of a corporation. You can see how this could engender concern about the development of a federal law of corporations and about whether the fraud was "in connection with" a securities transaction, as discussed below.

The Court stated that "Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities"[52] and that "[t]he Act protects corporations as well as individuals who are sellers of securities."[53] But the injury here was not the typical injury suffered by an investor who was defrauded. Both the buyer and the seller were happy with the price. Manhattan's injury occurred when the proceeds were misappropriated.[54]

Moreover, Manhattan was a unique corporate investor. It was not injured in a transaction involving its own equity securities, as in *Pappas v.Moss*.[55] In addition, it was,

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[49] *Bankers Life,* 404 U.S. at 9.
[50] *Id.*
[51] *Id.*
[52] *Id.* at 10.
[53] Superintendent of Ins. of State of N. Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971)..
[54] The Court later recognized a related theory on which to find violations of federal securities laws, which it termed the "misappropriation theory." *See* U.S. v. O'Hagan, 521 U.S. 642, 652 (1997). In a case dealing with insider trading, the Court found that a lawyer who traded on secret information he obtained while working for the corporation could be liable under Rule 10b-5. Even though no harm was caused to those selling to the "insider," the Court found that the lawyer "misappropriated" information from his employer, making him liable under Rule 10b-5. *Id.*
[55] 393 F.2d 865 (3d Cir. 1968). In *Pappas*, the board of directors voted to sell shares of the corporation to themselves at a price far below market-value. *Id.* at 867. The Third Circuit found that this sale violated Rule 10b-5 because the board of directors deceived the independent shareholders by selling stock cheaply to themselves. *Id.* at

in effect, selling part of its "inventory," since the "inventory" of a financial institution in part consists of securities. As stated above, if Manhattan were a construction company and sold its crane, there would not be a Rule10b-5 case and, as also stated above, the "investor," Manhattan, was not complaining about the price received in the transaction.

The opinion contained other expansive language. The fact that the fraud was committed by an officer, therefore, breaching his fiduciary duty to Manhattan, was "irrelevant" since Section 10(b) bars fraud by "any person."[56] Also irrelevant was the fact that this was a "private transaction," i.e., not conducted over an exchange or in the formal over-the-counter market and that the proceeds were "misappropriated."[57]

The Court did realize that there must be some connection between the fraud and a securities transaction, since the Court acknowledged "that Congress by §10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."[58] But the Court provided little guidance as to when fraud is "in connection with" a securities transaction when it held that Manhattan's injury was the result of "deceptive practices *touching* its sale of securities as an investor."[59]

Looking ahead to the next trilogy,[60] the opinion would have been on sounder ground if it would have held that Manhattan was not deceived since its sole shareholder, who controlled the board of directors, was the perpetrator of the misappropriation of the proceeds of sale. Instead, it created a tenuous connection between the fraud and the securities transaction, a connection even more tenuous than that which exists in insider trading under the misappropriation theory, which will be explored in connection with the third trilogy.[61]

While the result reached by the *Bankers Life* Court was not necessarily dictated by the language of the statute, by existing case law, or by the facts of the case, and can be criticized as being overly expansive in its view of Rule 10b-5, in contrast to the latest trilogy, the *Bankers Life* Court did little violence to statutory interpretation and was not diametrically inconsistent with existing case law.[62]

3. *Affiliated Ute Citizens:* Engendering Unnecessary Confusion

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868. The corporation itself was harmed because the board of directors acted against the interest of the corporation by improperly selling securities, which is different from misappropriating the assets of the corporation.

[56] *Bankers Life*, 404 U.S. at 10.

[57] *Id.*

[58] *Id.* at 12.

[59] Superintendent of Ins. of State of N. Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971) (emphasis added).

[60] See infra Part I.B.3 (discussing *Santa Fe*)

[61] See infra Part I.C.3 (discussing *Carpenter* and *O'Hagan*)

[62] See *infra* Part II.

Affiliated Ute Citizens v. United States[63] once again dealt with a complicated set of facts but, unfortunately, did so, not in a short opinion, but rather in an unnecessarily long one. A bank was appointed transfer agent for mixed-blood Indians with regard to stock they received in a corporation formed to hold assets for which distribution would otherwise be impracticable (including oil, gas and mineral rights and unliquidated claims against the U.S. government) received pursuant to the Ute Indian Supervision Termination Act.[64] Each mixed-blood Ute was to receive ten shares of Ute Distribution Corp. ("UDC"); however, instead of distributing the shares directly to the mixed-bloods, UDC deposited the shares with the bank and the bank issued receipts to the shareholders.

The primary focus of the litigation was the sale by eighty-five mixed bloods to two assistant managers at one of the defendant bank's branch offices and to thirty-two other white men. Sales by the mixed-bloods were at prices ranging from $300 to $700 per share. The District Court determined that the value of the stock was $1500 and found that the bank and employees were liable to the mixed bloods for damages.

Considering the state of the law respecting Rule 10b-5 at this time, this should have been a rather routine securities case. The basic ethic of Rule 10b-5 is that it is a sin not just to lie but also to tell half-truths. This is embodied in paragraph (b) of the Rule which makes it unlawful:

> To make any untrue statement of a material fact [a lie] or to omit 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 [a half-truth].[65]

On the other hand, the Supreme Court treated this as a "silence" case, in which materiality substitutes for reliance.

The Tenth Circuit, even though taking a constricted view of defendants' liability, recounted that, as to the purchases personally made by the bank employees, "the record shows that the individual defendants [represented] that the prevailing price or market price was the figure at which their own purchase was made."[66] According to the Tenth Circuit, this sufficed for liability on the personal purchases by the employees. However, the Tenth Circuit rejected liability for purchases by other white men on the basis that, in the other purchases, the employees performed only "ministerial" acts, such as preparing an affidavit that the mixed bloods had offered the shares to UDC.[67]

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[63] 406 U.S. 128 (1972).
[64] 25 U.S.C. § 677 (2011).
[65] 17 C.F.R. § 240.10b–5(b).
[66] Reyos v. U.S., 431 F.2d 1337, 1347 (10th Cir. 1970) aff'd in part, rev'd in part sub nom. Affiliated Ute Citizens of Utah v. U. S., 406 U.S. 128 (1972).
[67] *Id*. at 1346.

With respect to the purchases by the other white men, the Tenth Circuit acknowledged that one employee stated "I contacted a number of people [mixed bloods] telling them that if they were interested in selling, I was interested in offering the highest price."[68] The Tenth Circuit also stated:

> The record shows that the bank officials at the Roosevelt office of the defendant bank were active in encouraging a market for the UDC stock among non-Indians. This was probably not contemplated by the UDC-bank relationship. This gave rise to some indirect benefits to the bank by way of increased deposits, but it did not constitute a violation of any duty the bank may have had to the plaintiffs by contract or otherwise.[69]
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> The bank and the individual defendant employees had developed a market at the Roosevelt Agency of the bank for UDC stock, received inquiries from time to time for stock, and had customers of the bank who were prepared to make purchases from time to time. The defendant bank and the individual defendants were thus entirely familiar with the prevailing market for the shares at all material times.[70]

Even under Supreme Court's later, more restrictive definition of who is a seller under the 1933 Act, the activity of the bank and its employees could constitute them as purchasers with regard to the mixed-blood sales to other white men, since they solicited the purchases from the mixed-bloods.[71] Furthermore, since the employees, besides purchasing for their own account, were soliciting the mixed-bloods to sell and were soliciting or receiving orders from other white men to buy, the situation could certainly fall within clause (c) of Rule 10b-5: "[engaging] 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."[72] Thus the defendants could be liable for their fraud in the selling activity for both their own sales and those that they facilitated.

This latter approach is basically the tack taken by the District Court and the Supreme Court.[73] The Supreme Court began by taking an expansive view of the scope of Rule 10b-5, "Repeated use of the word 'any' [is] meant to be inclusive," so as to cover a broad variety of frauds.[74] In addition, the 1934 Act embraced a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor" and securities legislation should be construed "not technically and restrictively, but flexibly to effectuate its remedial

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[68] *Id.* at 1347.
[69] *Id.* at 1345.
[70] *Id.* at 1347.
[71] *Cf.* Pinter v. Dahl, 486 U.S. 622 (1988), where the Court, although rejecting the "substantial factor" test in determining who is a seller under the 1933 Act, determined that someone who actually solicited a sale could be a seller even though such person did not take title.
[72] 17 C.F.R. § 240.10b–5(c).
[73] 406 U.S. at 148, 153.
[74] *Id* at 151.

purposes."[75] Such an approach is a far cry from the outcome determinative approach embodied within the latest trilogy - - an approach which facilitates fraud rather than restricting it.

The Supreme Court, in *Affiliated Ute Citizens*, found a course of business embodying a scheme to defraud on the following basis:

> This is so because the defendants devised a plan and induced the mixed-blood holders of UDC stock to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell. [76]

So far so good. But the Court then went on to categorize the defendants as "market makers," an unnecessary characterization:

> The individual defendants, in a distinct sense, were market makers, not only for their personal purchases constituting 8 1/3% of the sales, but for the other sales their activities produced. This being so, they possessed the affirmative duty under the Rule to disclose this fact to the mixed-blood sellers. It is no answer to urge that, as to some of the petitioners, these defendants may have made no positive representation or recommendation. The defendants may not stand mute while they facilitate the mixed-bloods' sales to those seeking to profit in the non-Indian market the defendants had developed and encouraged and with which they were fully familiar. The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market.[77]

Not only did the Court refer to the defendants as market makers, but it also cited *Chasins*,[78] a case involving professional market makers, which had imposed a duty of disclosure upon market makers.

This case touched off a firestorm of concern.[79] While the bank and its employees were "making a market," they were not professional market makers.[80] Securities professionals who

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[75] *Id*. [cite Cap Gain question above

[76] *Id.* at 153.

[77] *Id*. (internal citation omitted) The Court referenced Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970), which dealt with the liability of a professional market maker and also the liability sections of the 1933 and 1934 Acts, dealing with liabilities for misrepresentations and omissions in registration statements and in SEC filings, 15 U.S.C. s 77k(a) and 15 U.S.C. s 78r(a).

[78] Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970).

[79] *See* Affiliated Ute Citizens v. United States—*The Supreme Court Speaks on Rule 10b-5*, 1973 Utah L. Rev. 119, 120-130 (1973) (explaining that while the Second Circuit in *Chasins* noted that identification as a market maker was material, it never found a duty to disclose such status—the Court's holding that market maker status must be disclosed should be limited to the facts of this case); and Arthur Fleischer, et. al. *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 846, 856-57 (1973) (discussing the problems created by *Affiliated Ute* for market traders engaged in continuous trading activity due to unresolved questions relating to the scope of this decision).

[80] Market-maker is defined by the SEC as an organization, association, or group of persons that "(1) Brings together the orders for securities of multiple buyers and sellers; and (2) Uses established, non-discretionary methods (whether

may make a market in several stocks and engage in hundreds of transactions a day were concerned with what disclosure obligations could be imposed upon them as a result of the *Affiliated Ute Citizens* decision.

B. The Reaction to the Development of Arguably a Federal Law of Corporations and the Second, "Conservative" Trilogy

The 1960s were a time of social and political upheaval, sparked in large part by the civil rights movement and the Vietnam war,[81] and to some extent by reaction to the liberal decisions of the Warren Court.[82] In 1968, one issue upon which President Nixon campaigned was that he would appoint a strict constructionist to be Chief Justice of the Supreme Court.[83] After his election, he made good on his promise, appointing Warren Burger as Chief Justice in 1969. He also had three other appointments: Blackman in 1970, and Powell and Rehnquist in1972. Three of the four turned out to be moderate to strong conservatives, but Blackman, to the chagrin of the conservatives, turned out to be a strong liberal, authoring the Court's opinion in Roe v. Wade,[84] which has had political repercussions up to the present.

Speaking of his appointments, President Nixon stated:

[85]

The conservative shift that Nixon accomplished is reflected in the next trilogy of cases. While the cases reflected movement away from the prior expansionist approach of the federal courts to Rule 10b-5, they also reflected, as President Nixon suggested, able constitutional lawyering.

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by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. 17 C.F.R. § 240.3b–16.

[81] *See e.g.*, Stephen Feinstein, The 1960s from the Vietnam War to Flower Power 60-61 (2006) (noting the significant events of the 1960s); Robert Buzzanco, Vietnam and the Transformation of American Life 1-9 (1999) (explaining the social and political movements of the 1960s). The Vietnam War, along with the assassinations of President John F. Kennedy, Martin Luther King, Jr., Robert Kennedy; the riots after the King assassination; the Peace Movement of the 1960s; the Women's Liberation movement of the 1960s; and the 1968 Chicago Democratic Convention all had significant impact on politics of the 1960s. *Id.*

[82] While Brown v. Board of Education, 347 U.S. 483, was a 1954 case, its progeny carried over to the 1960s and later. In addition, there were many other liberal decisions. *See e.g.*, Mapp v. Ohio, 367 U.S. 643 (1961) (holding evidence obtained by an unconstitutional search was inadmissible in trial, thereby nullifying the conviction); Reynolds v. Sims, 377 U.S. 533 (1964) (holding existing and proposed plans for apportionment of seats in the Alabama Legislature invalid under the Equal Protection Clause); Gideon v. Wainwright, 372 U.S. 335 (1963) (holding that defendants in a state court criminal prosecution have the right to have counsel appointed); Miranda v. Arizona, 384 U.S. 436 (1966) (holding that statements obtained from defendants without full warning of constitutional rights were inadmissible as a violation of the Fifth Amendment).

[83] Donald Grier Stephenson Jr., Campaigns and the Court: The U.S. Supreme Court in Presidential Elections 181 (1999) (noting Nixon's promise to nominate Supreme Court Justices who "would be strict constructionists who saw their duty as interpreting law and not making law" and who "would see themselves as caretakers of the Constitution and servants of the people, not super-legislators with a free hand to impose their social forces and political viewpoints on the American people").

[84] 410 U.S. 113 (1973).

[85] Nixon Era Legal Experts Revisit High Court Nominations -The New Nixon Blog, available at http://blog.nixonfoundation.org/2011/11/nixon-era-officials-re-visit-the-rehnquist-and-powell-nominations/

1. *Blue Chip Stamps:* Adoption of the "Birnbaum" Standing Rule

The first case in this trilogy, *Blue Chip Stamps*,[86] involved a very unique set of facts. Normally, the concern in a public offering is that the issuer, in preparing the registration or other offering documents, will be unduly "optimistic" in order that the investing public may be induced by misleading statements to buy and thus to be euchred into a bad investment. The converse occurred in *Blue Chip Stamps*.

Pursuant to a federal antitrust consent decree, "Old" Blue Chip and its controlling shareholders were required to offer stock in the "New" Blue Chip to retailers who had used the stamp service but were not shareholders, in proportion to their past stamp usage. The offering to the retailers would reduce the holdings of the nine retailers who previously had owned 90% of "Old" Blue Chip. It was to the advantage of those who controlled "Old" Blue that the retailers, to whom shares in "New" Blue Chip were offered, not purchase such shares. Consequently, according to plaintiff retailers, defendants prepared a prospectus that was fraudulently "pessimistic" in order to induce them not to buy.[87]

The so-called "Birnbaum" rule required that a plaintiff, in order to have standing to bring an action under Rule 10b-5 (which required that the fraud be "in connection with" a securities transaction) must have been a purchaser or seller of securities.[88] This rule was generally followed in the lower courts, although certain exceptions were recognized.[89] Because plaintiffs had neither bought nor sold securities, the District Court dismissed the complaint,[90] but a divided panel of the Ninth Circuit reversed the trial court on the basis that the instant facts fell within an exception to the Birnbaum rule.[91]

In the instant case, the Supreme Court declined to recognize an exception to the Birnbaum rule and made the rule an absolute standing requirement, subject to no exceptions. The majority opinion concluded:

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[86] 421 U.S. 723 (1975).
[87] *Id.* at 726.
[88] Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). Birnbaum was short and to the point; in contrast to the current, almost 50 page decision, Birnbaum was only 4 pages.
[89] *See e.g.*,Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967) (provided an exception.to the "Birnbaum Rule" where the plaintiffs are seeking injunctive relief, whereby no sale or purchase of the security is necessary where the plaintiff is seeking an injunction to prevent the wrongdoing); Landy v. Fed. Deposit Ins. Corp., 486 F.2d 139, 156 (3d Cir. 1973) (holding that a plaintiff seeking injunctive relief has standing after establishing a causal connection between the alleged violations and alleged injury, even without showing a purchase of sale of the security); Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967), cert. denied, 389 U.S. 970, 88 S.Ct. 463, 19 L.Ed.2d 460 (standing granted since shareholder was forced to sell his shares at a later time). *See also* Arnold S. Jacobs, Disclosure & Remedies Under the Sec. Laws § 9:5, Ns 64-119 (explaining the several exceptions to the Birnbaum Rule).
[90] Manor Drug Stores v. Blue Chip Stamps, 339 F. Supp. 35 (C.D. Cal. 1971) rev'd, 492 F.2d 136 (9th Cir. 1973) rev'd, 421 U.S. 723 (1975).
[91] Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136 (9th Cir. 1973) rev'd, 421 U.S. 723 (1975).

> Were we to agree with the Court of Appeals in this case, we would leave the Birnbaum rule open to endless case-by-case erosion depending on whether a particular group of plaintiffs was thought by the court in which the issue was being litigated to be sufficiently more discrete than the world of potential purchasers at large to justify an exception. We do not believe that such a shifting and highly fact-orientated 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.[92]

There is no question that permitting persons who are not purchasers or sellers to sue carries with it possibilities of abuse. Consider the *Texas Gulf Sulfur* case, previously discussed.[93] The corporation published a misleading press release; subsequent to the SEC action, private plaintiffs who had sold their shares after that press release initiated suits and prevailed. Professor Ruder, later chairman of the SEC, opined that these lawsuits worked to the disadvantage of the continuing shareholders who did not sell on the basis of the press release.[94]

Consider a pejorative spin on the foregoing. Assume the shareholders, prior to the press release, were composed of two groups: short term speculators and long term investors. Upon the issuance of the press release, the speculators would sell and the investors would hold. The recovery of the speculators could devastate the capital of the corporation since corporations frequently trade at significant multiples of book value.[95]

But what if those who neither purchased nor sold could sue. Potentially, then everybody in the world could claim that they would have bought "but for" the misleading press release. Such a situation could wipe out the corporation.

At trial, probably only a few potential investors would succeed. Discovery and cross-examination could demonstrate, in the case of Texas Sulfur Gulf, that the investor had never invested in mining stocks, or that he had sought no research on the corporation, or did not have the requisite liquidity to buy. But the litigation process itself can be costly, time consuming, and disruptive to the corporation and its management. Moreover, there is always the risk of success by the plaintiff. Accordingly, an unfounded lawsuit still may have settlement or strike suit value. As the concurring opinion pointed out:

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[92] *Blue Chip Stamps*, 421 U.S. at 755.
[93] *See supra* text at note 19.
[94] David S. Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423, 426 (1968).
[95] Assume a corporation trades at four times book value. If the book value is 100, then the pre-press release market value would be 400. If the market value were to lose 10% (to 360) upon the issuance of the press release but then increase 50% (to 540) after a corrective press release, the measure of damages would be $180 per share. If 20% of the shares traded between the two press releases, the corporation would lose 36% of its capital base. This could have a devastating impact upon the corporation and its patient investors. Judge Friendly, concurring in SEC v. Texas Gulf Sulphur, 401 F. 2d 833, 867 (2d Cir. 1968) warned that this type litigation could "lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers."

> Proving, after the fact, what 'one would have done' encompasses a number of conjectural as well as subjective issues: would the offeree have bought at all; how many shares would he have bought; how long would he have held the shares; were there other 'buys' on the market at the time that may have been more attractive even had the offeree known the facts; did he in fact use his available funds (if any) more advantageously by purchasing something else?[96]

Judge Hufstedler, dissenting in the Ninth Circuit below, put the issue into a concise perspective: "although [strike suits] are difficult to prove at trial, they are even more difficult to dispose of before trial."[97] By framing Birnbaum as an absolute standing requirement, the majority insured that meritless litigation brought by a person who neither purchased nor sold could be disposed very simply and inexpensively merely by filing a motion to dismiss for lack of standing.

In *Blue Chip Stamps*, the statutory analysis was sound: the statute and the Rule both spoke of "purchase or sale;" Rule 10b-5 was derived from section 17 of the 1933 Act, which covered offerees—a phrase deleted from the Rule;[98] and the SEC had unsuccessfully sought to have Congress expand section 10(b) to cover "any attempt to purchase or sell, any security."[99] Accordingly, the judicial craftsmanship was well done. Moreover, the policy concern was legitimate: "If §10b were extended to embrace offers to sell, the number of persons claiming to have been offerees could be legion."[100]

The only criticism that could be levied against *Blue Chip Stamps* is that the Supreme Court chose to bar a potentially meritorious case on the basis that there might be subsequent meretricious ones, thus raising the question whether this was the proper vehicle to adopt the current policy. Since the defendants were required to offer shares only to a particular group of plaintiffs, the potential liability was not to the world at large, but only to a discrete group.

2. Ernst & Ernst: Scienter mandated by Statute - A Lesson in Administrative Law

The conservative trend continued with Ernst & Ernst[101] where the Supreme Court rejected negligence as a basis for a Rule 10b-5 action and required a state of mind for the defendant which embraced "scienter." In a footnote, the Court defined scienter as a "mental

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[96] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 758 note 2 (1975)..
[97] Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136, 147 note 9 (9th Cir. 1973) rev'd, 421 U.S. 723 (1975).
[98] *Compare* 15 U.S.C. § 77q (2011) ("It shall be unlawful for any person in the *offer or sale* of any securities or any security-based swap agreement . . .") (emphasis added), *with* 15 U.S.C. § 78j (2011) ("[It is unlawful] to use or employ, in connection with the purchase or sale of any security . . .").
[99] 103 Cong.Rec. 11636 (1957); SEC Legislation, Hearings on S. 1178-1182 before a Subcommittee of the Senate Committee on Banking & Currency, 86th Cong., 1st Sess., 367-368 (1959); S. 2545, 85th Cong., 1st Sess. (1967); S. 1179, 86th Cong., 1st Sess. (1959).
[100] *Blue Chip Stamps*, 421 U.S. at 758-759.
[101] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

state embracing intent to deceive, manipulate or defraud."[102] However, the Court left the door open for private suits to be based upon a standard less than subjective intent to defraud by adding:

> In certain areas of the law, recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10b and Rule 10b-5.[103]

While President Nixon had succeeded in changing the liberal inclination of the Supreme Court, the Circuit Courts retained their "liberal" perspective into the 1980s, when President Reagan in effect imposed a litmus test upon all judicial nominees.[104] Consequently, in short order, all Circuits adopted recklessness as the standard under Rule 10b-5.[105]

Interestingly, the opinion dealt with a lawsuit against an aider and abettor.[106] Leston Nay was the president and controlling shareholder of First Securities; however, on the side, he ran a Ponzi scheme analogous to that of Bernie Madoff,[107] in which he induced investors to invest in escrow accounts which he personally managed and which he represented would yield a high rate of return. To avoid detection, he had a policy that no one could open his mail while he was gone from the office (the "mail rule"). He committed suicide, First Securities became bankrupt, and Ernst & Ernst was charged by plaintiff for aiding and abetting Nay's fraud by not uncovering the

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[102] *Id.* at 193, note 12.
[103] *Id*.
[104] I can speak from personal experience. When I was interviewed by the Justice Department in connection with a judicial appointment, concern was raised about an article I had written, *Civil Rights of the Mentally Retarded: Some Critical Issues*, 48 N. D. LAW. REV. 133 (1972). While the title just as easily could have been "A Cost/Benefit Approach to the Care and Education of the Retarded," it was difficult for those interviewing me to get past any expanded notion of civil rights. *See also* Stuart Taylor Jr., *The One-Pronged Test for Federal Judge*, N.Y. Times, Apr. 22, 1984, at E5 (stating that Reagan put ideology first in filling judicial vacancies).
[105] Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co.. 570 F.2d 38, 44-47 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); McLean v. Alexander, 599 F.2d 1190, 1197-98 (3d Cir. 1979); Phillips v. LCI Int'l, Inc., 190 F.3d 609, 620 (4th Cir. 1999); Dupuy v. Dupuy, 551 F.2d 1005, 1017 (5th Cir. 1977); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 (7th Cir.), cert. denied, 434 U S. 875 (1977); Harris v. Union Elec. Co., 787 F.2d 355, 369 n12 (8th Cir. 1986); Nelson v. Serwold, 576 F.2d 1332, 1336-37 (9th Cir.), cert. denied, 439 U.S 970 (1978); Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979); White v. Sanders, 689 F.2d 1366, 1367 n4 (11th Cir. 1982); and S.E.C. v. Steadman, 967 F.2d 636, 641 (D.C. Cir. 1992).
[106] The Court reviewed judgment on whether civil liability exists for aiding and abetting. *Ernst*, 425 U.S. at 193, note 7. Eighteen years later, the Court struck down aiding and abetting liability under Rule 10b-5, without recognizing how the current decision undercut its analysis in Central Bank. See infra Part II.A.
[107] Bernard Madoff was seen by most on Wall Street as a top trader who consistently achieved high returns for his clients while charging very low fees, who was able to maintain his success in both bull and bear markets. In December 2008, he was arrested for what he described as "a giant ponzi scheme." Mr. Madoff had for years been paying returns to certain investors using money he received from other investors. When a few clients sought to make a large withdrawal from their accounts, the scheme collapsed. Losses were estimated to be as high as $50 billion. Diana B. Henriques & Zachery Kouwe, *Prominent Trader Accused of Defrauding Client*, N.Y. TIMES, Dec. 11, 2008, at A1. *See also* Diana B. Henriques, *Madoff Is Sentenced to 150 Years for Ponzi Scheme*, June 29, 2009, at A1 (explaining that Madoff was sentenced to 150 years in prison for his Ponzi scheme.

mail rule. Ernst & Ernst was not charged with intentional misconduct but rather "inexcusable negligence."[108]

Once again, the opinion exemplified sound judicial reasoning. The Court first turned to the language of the statute. Section 10 of the 1934 Act makes it illegal to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance" in contravention of SEC rules.[109] In analyzing the language, the Court concluded that "[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that §10(b) was intended to proscribe knowing or intentional misconduct."[110] The Court then looked at the legislative history of the 1934 Act and found little bearing upon the interpretation+ of Section 10. However, what little history there was clearly was not inconsistent with the approach taken by the Court.[111]

Much of the opinion addressed and rebutted arguments by the SEC that Rule 10b-5 encompassed negligent conduct. The Court extensively addressed the SEC's argument that the structure of the securities acts supported Section 10 sounding in negligence. The SEC pointed out that Section 9(e) requires "willful[] participat[ion]"[112] while Section10(b) is not by its terms explicitly restricted to willing, knowing or purposeful conduct."[113] In response, the Court embarked upon its own analysis of the structure of the securities acts.

Looking first to the 1933 Act, the Court noted that the express liability provisions all sounded in negligence,[114] but also contained procedural protections, such as requiring plaintiff to post a bond[115] or imposing a shortened statute of limitation.[116] Since Rule 10b-5 protects buyers as well as sellers, plaintiff buyers could choose to bring suit under Rule 10b-5, instead of the aforesaid express liability provisions, and thereby short circuit these statutory protections for defendants in the case of negligent wrongdoing. The Court stated:

> We think these procedural limitations indicate that the judicially created private damages remedy under §10(b) which has no comparable restrictions cannot be extended,

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[108] Ernst & Ernst v. Hochfelder, 425 U.S. 185,190, note 5 (1976).
[109] 15 U.S. C. §78j(b) (emphasis added).
[110] *Ernst*, 425 U.S. at 197.
[111] In the concluding portion of its opinion, the Court stated: "When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances, the commonly understood terminology of intentional wrongdoing and its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct." *Id.* at 214.
[112] 15 U.S. C. §78i(e)
[113] *Ernst*, 425 U.S. at 207.
[114] Section 11(b), 15 U.S.C. §77k(b), imposes almost absolute liability on the issuer, but directors, underwriters, experts and officers who sign the registration statement are not liable if they can establish a due diligence defense. A similar defense exists under §12(a)(2), 15 U.S.C. §77l(a)(2), and controlling person liability under §15, 15 U.S.C. §770, may be avoided if the control person had no "reasonable grounds to believe" in the facts rendering the control person liable. Basically, a person who can establish that he or she was not negligent will not be liable.
[115] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 210 (1976).
[116] 15 U.S. C. §77m.

> consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by §§11, 12(2), and 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.[117]

The Court treated the 1934 Act provisions in a footnote.[118] Other than section 16(b), which was directed at officers, directors and ten percent shareholders and which essentially created absolute liability for "insider" trading encompassed within a six-month period,[119] the Court opined that all other express liability provisions had state of mind conditions. Section 9(e), as stated above, requires willful participation; section 18, dealing with filing misleading statements with the SEC, requires knowledge; and section 20, dealing with controlling person liability, requires that the controlling person "induce" the controlled person's act.[120] These latter two provisions are actually phrased as affirmative defenses.

In effect, the Supreme Court recognized that, if Rule 10b-5 sounded in negligence, Rule 10b-5, like Sherwin Williams's paint, could "cover the world" and make the express liability provisions superfluous.

The SEC also argued that the language of subsections (b) and (c) of Rule 10b-5, standing alone, support a negligence standard.[121] This argument, in part, was also the rationale for the dissent.[122] The majority easily disposed of an argument based upon the language of Rule 10b-5, rather than on the statute, by recounting well settled administrative law principles. The authority of the SEC to promulgate rules is limited by the rule making authority conferred by the statute.[123] The rule must implement the statute, not override it. Thus, if the statute gives the SEC power to proscribe fraud, the SEC does not have the power to proscribe negligence. The rule cannot be broader than the authority conferred by the statute. This probably accounts for the half-hearted dissent.

3. Santa Fe: Harmonizing State and Federal Law and Putting Closure on a Federal Law of Corporations.

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[117] *Ernst*, 425 U.S. at 210. (footnotes omitted).
[118] *Id.* at 209, note 28.
[119] 15 U.S.C. §77p(b) (the Court apparently saw Congress holding "insiders" to a higher standard than that applicable to persons generally).
[120] 15 U.S. C. §§78(i), 78(r) and 78(t), respectively.
[121] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976). In Aaron v. SEC, 446 U.S. 680 (1980), the Court held that similar language in a statute, § 17 of the 1933 Act, 15 U.S.C. § 77q, sounded in negligence, but the same language in Rule 10b-5 could not since the interpretation of the rule was controlled by the statute, § 10(b).
[122] *Id.* at 216-217 (Blackmun, J., dissenting).
[123] *See* Manhattan Gen. Equip. Co. v. Comm'r of Internal Revenue, 297 U.S. 129, 134 (1936) ("A regulation which . . . operates to create a rule out of harmony with the statute, is a mere nullity); and Miller v. United States, 294 U.S. 435, 439 (1935) (an administrative agency cannot create a rule that regulates anything beyond the what Congress enabled it to regulate through the plain meaning of the statute).

Santa Fe Industries, Inc. v. Green[124] is the last case in the trilogy of thoughtful and well-crafted conservative decisions limiting the scope of Rule 10b-5. As will be discussed, the policy perspective envisioned in the opinion actually played out in the controversy which gave rise, not just to the current opinion, but to two other cases as well.[125]

Santa Fe involved the short form merger of a subsidiary of Santa Fe, Kirby Lumber Corp.,[126] with another subsidiary of Santa Fe. No vote of the shareholders of Kirby was necessary, but the shareholders were entitled to ten days notice of the effectiveness of the merger and had the right to dissent and receive the judicially appraised value of their shares. Santa Fe furnished Kirby minority shareholders with an information statement containing an appraisal of the Kirby assets. While the physical assets were appraised at $640 per share, Morgan Stanley valued the shares at $125 per share and Santa Fe offered the minority shareholders $150 per share.

Rather than following through on their appraisal rights,[127] plaintiffs in the instant case filed suit under Rule 10b-5, alleging a scheme to defraud the minority shareholders out of the difference between the value of the physical assets and the $150 per share offered by Santa Fe. Both the District Court[128] and the Second Circuit[129] viewed plaintiffs' complaint as presenting two grounds for liability: (i) gross undervaluation and (ii) squeezing out the minority without a business purpose. Both courts agreed that gross undervaluation without any accompanying misrepresentation or lack of disclosure would not be actionable under Rule 10b-5. While the District Court held that Delaware law did not require a business purpose for a squeeze out merger,[130] the Second Circuit held that neither misrepresentation nor nondisclosure was necessary for a Rule 10b-5 action:

> We hold that a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short-form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose. The minority shareholders are given no prior notice of

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[124] 430 U.S. 462 (1977).
[125] See infra text at notes 140-142.
[126] Kirby was actually a subsidiary of a subsidiary and another subsidiary was formed which merged into Kirby, such that Kirby was the surviving corporation. The net effect of the corporate machinations was that the majority shareholders of Kirby were cashed out, and Santa Fe now had a wholly owned subsidiary. *Santa Fe*, 430 U.S. at 465.
[127] Initially, plaintiffs petitioned for appraisal, but then withdrew the petition and filed the federal lawsuit. Green v. Santa Fe Indus., Inc., 391 F. Supp. 849, 855 (S.D.N.Y. 1975) aff'd in part, rev'd in part, 533 F.2d 1283 (2d Cir. 1976) rev'd, 430 U.S. 462 (1977).
[128] *Id*.
[129] 533 F.3d 1283 (2d Cir. 1976).
[130] *Compare* Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del. 1983) (explaining that corporations need not have a valid business purpose when effectuating a merger) *with* Coggins v. New England Patriots Football Club, Inc., 397 Mass. 525, 534-35 (1986) (holding that under Massachusetts law, defendants must prove (1) the merger was for a legitimate business purpose, and (2) it was fair to the minority); and Bryan v. Brock & Blevins Co., Inc., 490 F.2d 563, 570 (5th Cir. 1974) (stating that the Georgia Corporation Merger Statute requires corporations to show a valid business purpose for a merger in order to avoid the statute's anti-fraud provisions).

> the merger, thus having no opportunity to apply for injunctive relief, and the proposed price to be paid is substantially lower than the appraised value reflected in the Information Statement.[131]

The Supreme Court, in reversing the Second Circuit, took essentially the same tack it took in *Ernst & Ernst*. It first looked to the language of the statute, focusing upon the words "manipulation and deception" in conjunction with "device or contrivance,"[132] and then reasserted that a rule cannot exceed the power conferred by Congress pursuant to the statute.[133] Consequently, the Court concluded that "the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can fairly be viewed as 'manipulative or deceptive."[134] Since the District Court found that there was no omission or misstatement of a material fact, plaintiffs had no cause of action.

The opinion could have concluded at this point but the Court also undertook a *Cort v. Ash*[135] analysis to drive home the point that breaches of fiduciary duty, unaccompanied by deception, are not within a private cause of action under Rule 10b-5. The Court asserted that the "fundamental purpose" of the securities laws was to implement a policy of "full and fair disclosure."[136] If there is full disclosure, then "the fairness of the terms of the transaction is at most a tangential concern."[137] Consequently, recognizing a cause of action merely for breach of fiduciary duty is not necessary to fulfill the purposes of the securities laws. Moreover, breach of fiduciary duty is an area traditionally relegated to state law. Accordingly, the Court rejected the possibility that Rule 10b-5 could be used to create a federal law of corporations.

> Federal courts applying a "federal fiduciary principle" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.[138]

In effect, the Court was harmonizing federal and state law. The purpose of federal law is to promote disclosure. Where, as here, full disclosure is made, there is no federal cause of action. However, if the fully disclosed facts reveal a basis for breach of fiduciary duty or other state remedy, the plaintiff has access to state law for a substantive remedy.

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[131] Green v. Santa Fe Indus., Inc., 533 F.2d 1283, 1291 (2d Cir. 1976) rev'd, 430 U.S. 462 (1977).
[132] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977).
[133] *Id*. at 472-473.
[134] *Id*. at 473-474.
[135] 422 U.S. 66 (1975).
[136] *Santa Fe*, 430 U.S. at 477-478.
[137] *Id*. at 478.
[138] *Id*. at 479.

This is exactly what occurred in the Santa Fe situation. While plaintiffs in the case before the Supreme Court failed in their federal action because Santa Fe made full disclosure, including the fact that the physical assets were worth $640 per share, substantially more than the $150 per share offered by Santa Fe, plaintiffs in two other lawsuits took advantage of this disclosure to initiate appraisal and breach of fiduciary duty actions. In a case filed in Delaware under the appraisal statute, plaintiffs recovered $254.40 per share;[139] on the other hand, in New York, plaintiffs filed a breach of fiduciary duty case, but were not successful because, as required by Delaware law, there was no fraud, misrepresentation or blatant overreaching.[140] Thus, the factual situation demonstrates the workability of *Santa Fe* limiting Rule 10b-5 actions to those involving deception since the disclosure provided by federal law would enable a plaintiff to take advantage of common law remedies.[141]

C. The Insider Trading Trilogy.

The next trilogy of cases, *Chiarella v. U.S.*,[142] *SEC v. Dirks*,[143] and *Carpenter v. U.S.*,[144] all dealt with insider trading and represent a significant departure from the sound reasoning reflected in the previous trilogy. They also represent a move toward constraining the scope of Rule 10b-5 in circumstances where its broad application would further the policy of the securities laws. While the previous trilogy put a brake upon the unwarranted expansion of Rule 10b-5, it did so by focusing on the language of the statute, which limits the scope of the rule; moreover, it did so in a manner that was not aimed at permitting fraudulent activity to escape accountability.

On the other hand, as will be demonstrated, the insider trading trilogy, and the final trilogy dealing with collateral participants, have encouraged illicit activity and undermined the purpose of the securities laws "to insure fair and honest functioning of impersonal national securities markets where common law protections have proved inadequate,"[145] or, as Congress has stated "to insure dealing in securities is fair and without undue preferences or advantages among investors."[146]

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[139] Bell v. Kirby Lumber Corp., 413 A.2d 137, 140 (Del. 1980).

[140] Green v. Santa Fe Indus., Inc., 514 N.E.2d 105, 113 (1987) (holding that the plaintiff's acceptance of the offer by Santa Fe was not made in reliance on any deception or omission on the part of defendants but was, on the contrary, the result of an informed judgment that resorting to an appraisal proceeding would be too costly and time-consuming).

[141] *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), undercut this schema somewhat by not finding maldisclosure actionable when the minority shareholders did not have sufficient votes to defeat the merger proposal. As, Justice Kennedy pointed out in his dissent, in this situation there is all the more need for full disclosure *Id.* at 1118. He asserted that the majority had engaged in "a sort of guerilla warfare to restrict a well-established implied right of action." *Id.* at 1115.

[142] 445 U.S. 222 (1980).

[143] Dirks v. SEC, 463 U.S. 646 (1983).

[144] Carpenter v. U.S., 484 U.S. 19 (1987). The Court, in U.S. v. O'Hagan, 521 U.S. 642 (1997), later accepted the misappropriation theory. *See infra* textat note 250.

[145] *Chiarella*, 445 U.S. at 248 (Blackman, J., dissenting).

[146] H.R. Conf. Rep. No. 94-229, at 91 (1975), U.S. Code Cong. & Admin. News 1975, at 323.

1. *Chiarella*: The Start of Retrenchment

Chiarella dealt with an employee of Pandick Press, a financial printer. He worked on five documents dealing with corporate takeover bids and, while the names of the bidder and the target were not disclosed to the printer until the night before the bids were made public, Chiarella was able to discern their identity and make pre-bid purchases at the then market price. After the takeover bids were made public, he sold the shares and realized a substantial gain.[147] Chiarella was first investigated by the SEC and entered into consent decree, disgorging his profits, and was then indicted by the U.S. Attorney and convicted on seventeen counts of violating Rule 10b-5. The scope of the indictment and the jury instructions were viewed differently by the majority and the dissenters.

According to the Court, the jury, pursuant to the District Court's charge, could convict Chiarella if it "found that he willfully failed to inform sellers of the target company's securities that he knew of a forthcoming takeover bid that would make their shares more valuable."[148] The Court opined that it could not affirm Chiarella's conviction "without recognizing a general duty between all participants in market transactions to forgo actions based upon material, nonpublic information,"[149] or, in other words, a broad duty to the market as a whole. This the Court refused to do. Instead, it asserted that silence[150] is actionable only where there is a duty to disclose and such a duty arises only from a common law relationship of trust and confidence between the parties to the transaction.[151]

The Court's decision is problematic in several respects. First of all, the Court is applying what it describes as the "catch all" provision of the 1934 Securities Exchange Act. The reason why the securities laws were enacted was that the common law was inadequate. Yet, the Court used the common law to constrict the scope of the securities laws. This is catch-22 reasoning. The Court opined that, while Rule 10b-5 is a catchall provision, "what it catches must be fraud."[152] But there is no question that Chiarella engaged in fraudulent activity. As Chief Justice Burger eloquently put in his dissent:

> "Chiarella, working literally in the shadows of the warning signs in the printshop, misappropriated -- stole to put it bluntly -- valuable nonpublic information entrusted to him in the utmost confidence."[153]

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[147] Over the course of 14 months, Chiarella made a profit of more than $30,000. *Chiarella*, 445 U.S. at 224. An attorney who worked on the case told me that the SEC was tipped to Chiarella's activity by a jilted boyfriend who thought his romance was undercut by his rival's new found wealth.

[148] Chiarella v. U.S., 445 U.S. 222,226 (1980).

[149] *Id.* at 233.

[150] The court treated this case as a "silence" case since Chiarella made no disclosure before he traded. *Id.* at 226.

[151] *Id.* at 230.

[152] *Id*. at 234-235.

[153] *Id*. at 245 (Burger, J., dissenting). Justice Berger also pointed out that "Chiarella, himself, testified that he obtained his informational advantage by decoding confidential material entrusted to his employer by its customers" and that Chiarella's counsel conceded " Mr. Chiarella got on the stand and he conceded, he said candidly, 'I used clues I got while I was at work. I looked at these various documents and I deciphered them and I decoded them and I used that information as a basis for purchasing stock.' There is no question about that. We don't have to go through a hullabaloo about that. It is something he concedes. There is no mystery about that." Id at 244-245.

In this connection, the Court positively cited *Cady, Roberts & Co.*[154] to support its position, without acknowledging that *Cady, Roberts* in fact undermined its opinion. As discussed earlier, *Cady Roberts* dealt with a bad news situation in which an insider would sell, very likely, to someone who was not a shareholder. The defendant argued that there was not a common law fiduciary duty by a corporate insider to someone who was not a shareholder. The SEC took the position that the securities laws are not constrained by common law concepts.

Cady, Roberts involved a "traditional insider" as tipper and "company specific" information. Tenders offers present a different paradigm. The diagram set forth in Appendix A illustrates the situation. Below the bidder are what are sometimes referred to as "temporary insiders," such as attorneys and investment bankers. And the relevant information is not company specific, but rather "market information."

The majority focused upon the fact that Chiarella had no relationship, and thus no common law duty, to the shareholders of the target corporation. Chief Justice Burger, with a conservative "tough on crime" perspective, focused upon the fact that Chiarella stole confidential information from his employer to obtain an illicit gain.

While the Court, in applying "disclose or abstain," found an obligation to disclose only when the defendant owed a duty to the person on the other side of the transaction, Justice Burger found the duty to disclose became operative because of the illicit manner in which the defendant obtained the information. He found support from Professor Keeton:

> The way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part . . . . *Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information*.[155]

Justice Burger also found support in the repeated use of "any" in the statute: section (b) made illegal "*any* person engaged in *any* fraudulent scheme,"[156] and concluded that "congressional concern was [not] limited to trading by 'corporate insiders' [and that] Congress cannot have intended one standard of fair dealing for 'white collar' insiders and another for the 'blue collar' level."[157]

Finally, Justice Burger looked at legislative history which indicated that the purpose of the securities laws was to prohibit "manipulative and deceptive practices which have been

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[154] 40 SEC 907 (1961) (discussed *supra* text at note 29.30).
[155] Keeton, *Fraud-Concealment and Non-Disclosure*, 15 TEXAS L.REV. I, 25-26 (1936) (emphasis added).
[156] Chiarella v. U. S., 445 U.S. 222, 240 (1980) (Berger, J., dissenting).
[157] *Id*, at 240-241.

demonstrated to fulfill no useful function,"[158] and to "assure that dealing in securities is fair and without undue preferences or advantages among investors."[159] He then concluded that:

> An investor who purchases securities on the basis of misappropriated nonpublic information possesses just such an 'undue' trading advantage; his conduct quite clearly serves no useful function except his own enrichment at the expense of others.[160]

Justice Burger's approach makes more sense than that of the majority, which is predicated upon the existence, or lack thereof, of a common law fiduciary duty. Since the securities laws were enacted because of the shortcomings of the common law in dealing with securities fraud, why then look to the common law to interpret the securities laws? On the other hand, Justice Burger was guided by the policy behind the securities laws. As the SEC stated in *Cady, Roberts*, in view of the "broad language of the anti-fraud provisions, we are not to be circumscribed by distinctions and rigid classifications."[161] Accordingly, the SEC concluded:

> Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.[162]

Justice Burger's position is not quite a "possession" standard. But it is not burdensome to expect that corporate insiders and securities professionals should know that it is illegal for them to trade on material, non-public information. The doctrine of scienter would limit the persons subject to liability. This, of course, would make it easier to surmount a motion to dismiss, whereas Justice Burger sought to encourage disposing of litigation on a motion to dismiss in *Blue Chip Stamps.*

The majority may have been led astray by the inept phrase "disclose or abstain," which originated in the *Texas Gulf Sulphur* case.[163] The fallacy with phrasing the duty as disclose or abstain is that, invariably, the person subject to this adage has a duty not to disclose. For example, in *Texas Gulf Sulphur*, the employees had a duty to their employer not to disclose while the corporation assessed the scope of the discovery and obtained additional mineral rights. Thus, the employee did not have the option of disclosing or abstaining. [164]

The Second Circuit should have articulated the employees' obligation as "abstain until disclosable." If that were the jargon with which the federal courts were grappling, the Supreme Court might have upheld Chiarella's conviction since this latter standard does not implicate any duty to the shareholders of the target company. Holding a person like Chiarella accountable for

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[158] *Id* at 241 (quoting S.Rep.No. 792, 73d Cong. 2d Sess., 6 (1934)).
[159] *Id.* at 241 (quoting H.R.Conf.Rep.No.94–229, p. 91 (1975); U.S.Code Cong. & Admin.News 1975, p. 323).
[160] *Id.* at 241.
[161] 40 SEC at 910.
[162] *Id* at 911.
[163] See supra discussion at notes19-28.
[164] The *Dirks* case, *discussed infra* note 168, involved one of the rare instances where "disclose or abstain" might actually work.

stealing his employer's information in order to obtain an informational advantage is certainly consistent with the securities law policies recounted by Justice Burger.

In the long run, Justice Burger's position prevailed. His closing comment that Chiarella, "working literally in the shadows of the warning signs in the printshop, misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence," [165] became the basis for the misappropriation theory. A year later, the misappropriation theory was the basis of a conviction in *U.S. v. Newman*,[166] and four years later, in a case involving facts that were a clone of those in *Chiarella*, the conviction of an employee of a financial printing was upheld on the basis that he "misappropriated—state to put it bluntly—valuable nonpublic information" entrusted to him by his employer.[167]

2. *Dirks*: A Clear Policy Choice Favoring Greed over Investors

a. The Basic Facts

Dirks v. S.E.C.[168] involved a very strange and convoluted set of facts which may, in part, account for the divergence between the majority and minority opinions. It is as if the members of the Supreme Court were watching two different movies: the majority seeing a hero and the dissent seeing a villain.

The underlying facts were close to unbelievable. Equity Funding was an insurance company that sought to increase its earnings. Unfortunately, not enough real people were buying its policies. So it began creating people, who then bought policies so as to increase revenue. Now, in the insurance business there are both inflows and outflows, as people die and the beneficiaries collect on the policies. So Equity funding also killed some people—fortunately, these persons were only fictitious to begin with.[169]

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[165] Chiarella v. U. S., 445 U.S. 222, 245 (1980)
[166] 664 F. 2d 12 (2d Cir. 1987).
[167] SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984).
[168] 463 U.S. 646 (1983).
[169] The SEC found:

> "Since 1970, EFCA had been creating fictitious life insurance policies, known to insiders as "Y business." These policies were sold to reinsurers for an amount equal to 80% of first-year premiums. By this method, management hoped to generate cash flow, maintain an impressive growth rate and boost the value of EFCA stock. In some cases, legitimate policies were reinsured for more than their face amount, while at other times totally fictitious policies were created. To carry out this scheme, EFCA created supporting files, medical records and death certificates for non-existent policy holders, bribed and intimidated some of its auditors and state examiners, and falsified its financial records to show the receipt and disposition of non-existent premiums. Secrist claimed that he had actually witnessed the creation of fictitious files which were used to deceive EFCA's auditors. He asserted that, as a result of such activities, many EFCA employees had left the company. He estimated that, by 1972, EFCA carried at least 40,000 fictitious policies on its books, representing at least one-third of EFCA's outstanding life insurance business."

In the Matter of Raymond Dirks, 1981 WL 36329, *2 (S.E.C. Release No.) (footnotes omitted).

A disgruntled former executive, Ronald Secrist, in early 1973, tipped Raymond Dirks, an officer of a broker-dealer firm who specialized in insurance company securities, about the scam and asked him to publicize it. Secrist estimated that, by 1972, Equity Funding had 40,000 fictitious policies, about one-third of its business.[170] Dirks interviewed Equity Funding employees and, while management denied the charges, some employees corroborated Secrist's story.

Dirks then took two divergent courses of action. He disclosed what he had learned to a number of clients and investors, including five institutional investors who liquidated more than $16 million in Equity Funding investments.[171] As the SEC opinion chronicles, Dirks had numerous conversations with these investors and even arranged contacts between them and former employees of Equity Funding. Dirks also opined that Equity Funding stock would soon stop trading and that the stock should be sold.[172] In return, Dirks received additional business; the majority and minority took differing views as to the effect of this upon Dirks' motivation.[173]

However, Dirks also contacted Equity Funding's auditors and the Wall Street Journal, which, after following up on Dirks' information, contacted the SEC which then called Dirks in. The majority asserts then the Wall Street Journal declined to write the story,[174] while the dissent asserts that the Wall Street Journal investigated and informed the SEC.[175] The same day Dirks met with the SEC, March 27, 1973, the New York Stock Exchange suspended trading because of the increased trading volume and the precipitous drop in price from $26 per share to $15.[176] Also at this time, the California and Illinois Departments of Insurance were investigating Equity Funding and were preparing to shut down its operations.[177]

b. The Divergent Views of the Majority and Minority

In view of the foregoing facts, consider the differing approaches of the majority and minority. According to the majority, the SEC had "concluded" in disciplining Dirks that:

> Where 'tippees'—regardless of their motivation or occupation—come into possession of material 'information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading.[178]

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[170] *Id*.
[171] *Dirks*, 463 U.S. at 649.
[172] *Matter of Dirks*, 1981 WL 36329, at *2-*5.
[173] The majority focused upon the SEC finding that Dirks "played an important role in bringing [Equity Funding's] massive fraud to light," (*Dirks*, 463 U.S. at 651-652), while the dissent focused upon the fact that Dirks and his firm "gained both monetary rewards and enhanced reputations for 'looking after' their clients" (*Id*.. at 670, n. 4 (Blackmun, J., dissenting)) by enabling them to "dump[] stock on unknowing purchasers." (*Id*. at 671).
[174] Dirks v. S.E.C., 463 U.S. 646, 649-650 (1983).
[175] *Id*. at 670
[176] *Id*.
[177] In 1983, I was Deputy Attorney General for Illinois, and Illinois insurance officials informed me that they were preparing a "raid" on the offices of Equity Funding at the time the story broke.
[178] *Dirks*, 463 U.S. at 651 (quoting 21 S.E.C. Docket 1401, 1407).

While the foregoing quotation is found in the SEC's opinion, it is not the conclusion or holding of the SEC; rather the SEC concluded:

> In sum, Dirks [an analyst] came into possession of material, non-public corporate information, from persons who he knew were insiders, at a time when he knew that the information was confidential and not then publicly available. He communicated that information to those likely to trade before the information became generally available. In committing these acts, Dirks acted with scienter. Accordingly, we conclude that Dirks willfully aided and abetted violations by Boston, Dreyfus, TZP, M&N and Bristol of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10-5 thereunder.[179]

There are two fundamental differences between the two "conclusions." The SEC did not rely on "disclose or abstain," but rather found Dirks liable as an aider and abetter because he disclosed confidential information to persons who would sell before the information would be publicly available. In this regard, the SEC opinion was a forerunner of Rule 10b5-1.[180]

Second, the SEC clearly focused upon scienter. This is a key element in insider trading—one that provides the proper bounds to limit the scope of who is subject to the insider trading proscriptions. Dirks was a securities professional who knew the information was material,[181] knew the information was non-public, knew that it was given to him in confidence to publicly disclose, and knew that his tippees would sell before public disclosure.[182]

The Court began its analysis of the issues raised by the SEC sanctioning of Dirks by again referencing *Cady, Roberts* as a seminal case, without realizing that the Cady Roberts decision sanctioned a securities professional who was tipped by an insider who did not "sin; in other words, *Cady, Roberts* was in direct opposition to the approach ultimately taken by the Court in *Dirks*.[183]

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[179] In the Matter of Raymond L. Dirks, 21 S.E.C. Docket 1401, 1410 (S.E.C. Release No. 1981).
[180] 17 C.F.R. §240.10b5-1 (promulgated in SEC Release Nos. 33-7881, 34-43154 2000).
[181] As the SEC stated:

> "The inside information to which Dirks had become privy demonstrated, in the words of one commentary, that "one of the darlings of Wall Street, a company that had managed to produce continued high earnings for a decade, *** was, instead, a gigantic fraud." Under the circumstances, it took little insight into the operations of the market – and Dirks was, of course, a highly experienced and highly sophisticated analyst – to recognize that anyone who held EFCA shares and became aware of the information in Dirks' possession would have a strong incentive to sell before that knowledge became widespread. Indeed, Dirks expressly advised at least one of those whom he tipped to sell, and he observed that others did so even without an explicit recommendation, based on his revelations. Accordingly, we find that Dirks knew or should have known that his selective disclosure of the information he had gleaned from the EFCA insiders would result in trading."

In the Matter of Raymond L. Dirks, 1981 WL 36329, *9 (S.E.C. Release No.) (footnotes omitted).
[182] Parenthetically, this is one of the rare times that "disclose or abstain" made sense: Dirks did have the option (if not the obligation) to disclose publicly the confidential information he had received. Absent such a disclosure, he had the obligation to abstain.
[183] 40 S.E.C. 907 (1961).

The Court, in Part III of its opinion, accepted the concept set forth in *Cady, Roberts* that, for there to be a violation of Rule 10b-5 in an insider trading context, two elements must be met: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."[184]

But, relying on *Chiarella*, the Court asserted that "a duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information. Such a duty arises rather from the existence of a fiduciary relationship."[185]

Again, *Cady, Roberts* rejected the argument that a duty under the securities laws derived from common law fiduciary concepts.[186]

However, the Court concluded Part II of its opinion by affirming the *Cady, Roberts* principle that "an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes 'secret profits.'"[187]

At this point it is not clear where the Court is going. But the Court then runs amuck in Part III, beginning its analysis by recognizing that a "typical tippee" generally has no common law fiduciary relationship.[188] The SEC had taken the position that a tippee who receives confidential non-public material information from an insider is subject to the same constraints as the insider.[189] Following *Chiarella*, the Court *rejected* the proposition that "'[*a*]*nyone* –corporate insider or not- who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose.'"[190] However, it did acknowledge: "The conclusion that recipients of inside information do not invariable acquire a duty to disclose or abstain does not mean that such tippee always are free to trade on the information. The need for a ban on some tippee trading is clear."[191]

What is the "some tippee trading" that is forbidden? According to the Court:

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[184] *Dirks*, 463 U.S. at 653-654 (quoting *Chiarella*, 445 U.S. at 227).
[185] Dirks v. S.E.C., 463 U.S. 646, 654 (1983).
[186] *Cady, Roberts*, 40 S.E.C. at 911.

> Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.

Id. (footnote omitted).
[187] *Dirks*, 463 U.S. at 654 (quoting Cady, Roberts, 40 SEC at 916, n. 31).
[188] *Id.* at 655.
[189] Id at 655-656 (quoting Dirks, SEC Docket at 1410, n. 42).
[190] Id at 656.
[191] Dirks v. S.E.C., 463 U.S. 646, 659 (1983).

> Thus, some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*. And for Rule 10b-5 purposes, the insider's disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[192]

Besides inferring that insider trading liability is the exception rather than the rule by repeated use of "some," the Court then waffled on when an insider breaches his fiduciary duty of non-disclosure: "All disclosures of confidential corporate information are not inconsistent with the duty insiders give to shareholders."[193] Consequently:

> Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.[194]

As indicated above, the dissent had an entirely different view of both the law and the facts. With respect to the facts, the dissent observed:

> In disclosing that [inside] information to Dirks, Secrist intended that Dirks would disseminate the information to his clients, those clients would unload their Equity Funding securities on the market, and the price would fall precipitously, thereby triggering a reaction from the authorities.[195]

The dissent also focused upon the fact that Dirks was "compensated" for "looking after" his clients[196] and that his efforts to bring the fraud to light were "feeble."[197] Dirks informed his clients before making any attempt to contact the SEC. To the minority, Dirks was no hero who brought to light a fraud, that otherwise might have gone undiscovered,[198] but, rather, a market

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[192] Id at 660 (emphasis in original) (footnotes omitted).
[193] Id at 661-662.
[194] Id at 662 (footnote omitted).
[195] *Id.* at 669 (Blackmun, J., dissenting). The dissent also opined: "But this is precisely what Secrist did. Secrist used Dirks to disseminate information to Dirks' clients, who in turn dumped stock on unknowing purchasers. Secrist thus intended Dirks to injure the purchasers of Equity Funding securities to whom Secrist had a duty to disclose." *Id.* Accepting the Court's view of tippee liability, it appears that Dirks' knowledge of this breach makes him liable as a participant in the breach after the fact.
[196] Id at 669-670.
[197] Dirks v. S.E.C., 463 U.S. 646, 670 (1983) (Blackmun, J., dissenting)..
[198] As stated earlier, state officials were in the process of shutting down Equity Funding's scam. See supra text at note 177. See also *Dirks*, 463 U.S. at 668 (Blackmun J., dissenting).

professional who knew his actions would injure most of the shareholders[199] while enabling his clients to avoid a major loss.[200]

With respect to the law, the dissent, responding to the majority's holding that Dirks was not liable because Secrist did not obtain any personal benefit and thus did not violate his duty to Equity Funding, stated that "the Court imposes a new, subjective limitation on the scope of the duty owed by insiders to shareholders. The novelty of this limitation is reflected in the Court's lack of support for it."[201] The minority asserted that "[t]he fact that the insider himself does not benefit from the breach does not eradicate the shareholder's injury."[202] According to the minority, "The duty is addressed not to the insider's motives, but to his actions and their consequences on the shareholder. Personal gain is not an element of the breach of this duty."[203] The reach of the duty is circumscribed by the requirement of scienter.

C. The Failed Policy Chosen by the Supreme Court

Consider now the differing opinions from a policy standpoint. In this case, there were two interests in conflict: those of the shareholders and the investing public that bought from Dirks' tippees, on the one hand, and those of analysts and others who wish to take advantage of non-public information they had obtained, on the other hand. Since the purpose of the securities laws in general is to insure "the maintenance of fair and honest markets" [204] and of section 10 in particular to support "the public interest" and insure "the protection of investors,"[205] whose interests should be paramount to the Supreme Court: those of Dirks and his tippees who saved millions of dollars by bailing out early on the basis of material non-public information, or those of the shareholders who were denied the opportunity to sell on the basis of Dirks' information and the investors who bought from the tippee institutions only to find that they owned a defunct company?

While the majority favored the analysts and institutions that wanted to make a fast buck, the dissent championed the shareholders and investors. For the majority, opportunists are favored over the investing public. This is a pattern that continued through *Central Bank, Stoneridge Investment Partners,* and *Janus Capital*[206].

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[199] Once disclosure is publicly made, all shareholders have a comparable opportunity to sell as the price declines. As a result of the Dirks actions, the uninformed shareholders were not informed until after the stocks had plummeted.
[200] See supra text at notes 172-173.
[201] *Dirks*, 463 U.S. at 671 (Blackmun, J., dissenting).
[202] *Id*. at 673. The minority added: "It makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transactions; the shareholder still has lost because of the insider's misuse of nonpublic information." *Id.*
[203] *Id.* at 674 (footnotes omitted).
[204] 15 U.S.C. § 78b.
[205] 15 U.S.C. § 78j.
[206] *See infra* Part II.

The majority in *Dirks*, as it continued its pattern of cutting back on the scope of Rule 10b-5, was overly enamored of the importance of analysts to the functioning of the securities markets. The majority rejected the SEC position that those receiving material, non-public information from a corporate insider had a duty to disclose or abstain (more properly, abstain until disclosed) on that basis that such an approach "could have an inhibiting influence on the role of market analysis.[207]

According to the majority:

> It is commonplace for analysts to ferret out and analyze information, and this is often done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm.[208]

The Court opined [erroneously as we will see][209] that "[i]t is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally."[210] While the majority recognized that Dirks' startling information "required no analysis"[211] it opined that "the principle at issue here extends beyond these facts."[212]

In taking this position, the Court was not embodying a conservative approach because the majority focused not upon the facts of the case before it, but rather "legislated," as it did in *Blue Chip Stamps*,[213] to solve a problem not then presented to the Court. Moreover, the majority opinion reflects a lack of understanding of the corporation's role in disclosing material information and the analyst's role in uncovering information.

Contrary to the opinion, it is possible to disclose material information in a public fashion. The SEC has adopted Regulation F-D,[214] which requires that, when a corporation or a person acting on its behalf discloses material, non-public information, it shall simultaneously disclose such information to the public or, in the case of inadvertent disclosure, as promptly as possible.[215]

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[207] Dirks v. S.E.C., 463 U.S. 646, 658 (1983).
[208] *Id*. at 658-659.
[209] See infra text at notes 214-215.
[210] *Dirks*, 463 U.S. at 659.
[211] *Id* at 658, note 18.
[212] *Id*.
[213] See supra text at note 86.
[214] 17 C.F.R. §243.100-, eff. Nov. 21, 2011.
[215] 17 C.F.R. §243.100(a).

With respect to the proper role of analysts, the S.E.C. opinion in *Dirks* should have provided insight to the Supreme Court as to what a legimate analyst actually does:

> In this connection, it is important to recognize that this is not a case in which a skilled analyst weaves together a series of publicly available facts and non-material inside disclosures to form a "mosaic" which is only material after the bits and pieces are assembled into one picture. We have long recognized that an analyst may utilize non-public, inside information which in itself is immaterial in order to fill in "interstices in analysis." That process is legitimate even though such "tidbits" of inside information "may assume heightened significance when woven by the skilled analyst into the matrix of knowledge obtained elsewhere," thereby creating material information.[216]

The SEC opinion, while recognizing the importance of an analyst's work and the legitimacy of tracking down rumors, concluded that "the analyst's role, like that of any other person, is constrained by the well-established proscriptions of the antifraud provisions of the federal securities laws, and we cannot condone the unfairness inherent in the selective dissemination of material, inside information prior to its public disclosure."[217]

Clearly the position of the SEC and the dissent is true to the purposes of the securities laws, while the position of the majority undercuts the protection of investors.

Subsequent events in the 2000s have brought into question the integrity of the analyst community and the quality of its analysis. Enron was a highly touted stock that also was the darling of the analysts until Bethany McLean questioned its business model and earnings.[218] Thereafter, Enron's scam was revealed and its stock became worthless.[219] Later, after the dot-com bubble burst, New York Attorney General Eliot Spitzer uncovered a flood of recommendations by analysts touting stocks for the public to buy that they were at the same time disparaging as "crap" to their colleagues.[220] Their motivation frequently was to obtain underwriting commitments for the investment banking side of their firm.[221] Sometimes the

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[216] In the Matter of Raymond L. Dirks, 1981 WL 36329 (S.E.C. Release No.), 7.
[217] *Id.* at *10
[218] Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001, *available at* http://money.cnn.com/2006/01/13/news/companies/enronoriginal_fortune/index.htm.
[219] In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002)
[220] *See* Christopher Lucas, *The Triangle Shirtwaist Fire and the Merrill Lynch Analyst Ratings Scandal: Legislative and Prosecutorial Responses to Corporate Malfeasance*, 1 BROOK. J. CORP. FIN. & COM. L. 449, 463-464 (2006) (Spitzer found emails describing stock as "a POS [piece of sh-t]" from an analyst that publicly described that same stock as "an attractive investment"); Joseph Nocera & Abrahm Lustgarten, *Wall Street on the Run*, FORTUNE, June 14, 2004, at 107 (explaining the settlements reached between the New York attorney general and Wall Street investment banks after Spitzer learned of analysts' routine betrayal of investors); and SEC Complaint against Henry Blodget, paragraph 86 *available at* http://www.sec.gov/litigation/complaints/comp18115b.htm (explaining that the public research reports by analysts were inconsistent with the analysts' privately expressed negative views.
[221] *See*Pat Huddleston II, et. al. *Protect Investors from Brokers' Stock Scams*, TRIAL, Apr. 2003, 37-39 (explaining that analysts recommended stocks in order secure investment-banking business, with no regard for the true financial conditions of the corporations).

motivation was merely to get a daughter into nursery school.[222] The Court should no longer be overly solicitous about holding analysts to account.

d. The Problem of Tone, the Explosion of Insider trading, and the Congressional Response

In the course of its opinion, the Court asserted:

1. [O]nly some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information.
2. Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading.
3. [T]he disclose-or-refrain duty is extraordinary.[223]
4. [A] duty [to disclose] arises ... not merely from one's ability to acquire information because of his position in the market.[224]
5. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders.[225]
6. Absent some personal gain, there has been no breach of duty to stockholders.[226]
7. *Chiarella* made it explicitly clear there is no general duty to forgo market transactions "based on material, nonpublic information."[227]
8. In one sense, as market values fluctuate and investors act on inevitably incomplete or incorrect information, there always are winners and losers; but those who have "lost" have not necessarily been defrauded.[228]

These observations created a tone that arguably contributed to a rash of insider trading that followed the *Chiarella* and *Dirks* decisions in the 1980s and which were extensively chronicled by a Wall Street Journal reporter in Den of Thieves.[229] Correlation does not mean causation but pronouncements such as the Supreme Court made could well have led to disdain by many in the investment banking community toward a proscription against insider trading. There is no question that insider trading increased markedly in 1980s. In 1984, a Congressional Report opined that "[i]nsider trading has become a more widespread problem in recent years," and the SEC "has brought more such cases during the past four years than in all previous years combined."[230] The Report also opined that "if the *Dirks* decision is properly and narrowly

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[222] Gretchen Morgenson & Patrick McGeehan, *Wall St. and the Nursery School: A New York Story*, N.Y. TIMES, Nov. 14, 2002, *available at* http://www.nytimes.com/2002/11/14/business/wall-st-and-the-nursery-school-a-new-york-story.html.
[223] Dirks v. S.E.C., 463 U.S. 646, 657 (1983).
[224] Id. at 658-659.
[225] Id. at 661-662
[226] Id. at 662.
[227] Id. at 666, note 27.
[228] Id.
[229] JAMES B. STEWART, DEN OF THIEVES (1991)
[230] House Report No. 98-355, at 5 (2278).

construed by the courts, the Commission's insider trading program will not be adversely affected.[231]

In response to the surge of insider trading, Congress twice took action in an attempt to curtail this activity: in 1984, with the Insider trading Sanctions Act,[232] and in 1988, with the Insider Trading Securities Fraud Enforcement Act.[233] The 1984 Act incorporated a potential treble damage liability for those who engaged in insider trading.[234] Courts of appeal decisions first had looked askance at the "draconian" liability when damages were measured, not by the benefit to the guilty party but by the loss suffered by all investors who traded contemporaneously,[235] and then limited recovery to the benefits obtained by a defendant who illegally traded.[236] The problem with merely requiring the defendant to disgorge his or her profits is that there is no downside (other than a potential criminal sanction) to engaging in insider trading. If you do not get caught, you win; if you do get caught, you merely return your ill-gotten gain. To put additional teeth in insider trading enforcement, the SEC requested, and Congress conferred, the "treble damage penalty provision."

Notwithstanding this new enforcement tool, in 1988 another Congressional Report asserted that "the last few years have seen a dramatic increase in insider trading cases, including cases against some of the most prominent officials in Wall Street investment banking firms."[237] Accordingly, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988. This act expanded the civil penalty provision to include broker-dealers, investment advisors and others who failed to take appropriate steps to prevent insider trading by incorporating the prior penalty provisions into a new section 21A of the 1934 Act.[238] Since the logic of the *Fridrich* decision[239] had effectively undercut the causation aspect of private insider trading litigation, Congress resuscitated this cause of action by providing for insider liability to contemporaneous traders.[240] But since damages were limited by the insiders benefit, this provision has been rarely be used unless the insider's gain was very substantial.

3. *Carpenter*: The Uncertain Status of the Misappropriation Theory

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[231] Id at 15 (2288).
[232] Pub. L. 98-376.
[233] Pub. L. 100-704.
[234] Pub. L. 98-376, S2, adding a new subparagraph (d)(2)(A) to section 21 of the 1934 Act, codified at 15 U.S.C. §78u(d)(2)(A).
[235] In Fridrich v. Bardford, 542 F.2d 307 (6th Cir. 1976), one insider's profit was $13,000, but was subjected by the District Court to a judgment of $361,186.75. In reversing the lower court, the Sixth Circuit characterized this as "Draconian liability." Id. at 309. The concurring opinion suggested that liability only attach to those plaintiffs who traded "contemporaneously" with the insider. Id at 327 (Celebrezze, J., concurring). The 1988 Act adopted this approach. Fredrich also questions whether an insider who did not abstain "caused" the party on the other side of the transaction to trade. Id at 323 (majority opinion).
[236] Elkind v. Liggett & Myers, 635 F.2d 156 (2d Cir. 1980).
[237] House Report No. 100-910, at 11 (p6048)
[238] Publ.L. 100-704, §3; codified at 15 U.S.C.§78u-1.
[239] See supra note235.
[240] Pub.L. 100-704, §3, codified at 15 U.S.C.§78t-1.

Carpenter v. U.S.[241] was another case involving unusual facts. David Carpenter, a roommate of R. Foster Winans, was a big player in a fraud concocted by Winans and Peter Brandt, a distinguished broker with Kidder Peabody.[242] Winans wrote an influential column, "Heard on the Street," for the Wall Street Journal. In his column, Winans applauded certain stocks and downplayed others. Stocks frequently rose after a positive column and fell after a negative one. Winans tipped Brandt as to the publication date and nature of the column and Brandt would buy before a positive column and go short before a negative one.[243] After the column was published and the stock moved, Brendt would close out the transaction. Over a four month period, the scheme netted almost $700,000.[244]

In 1987, the decision of the Supreme Court in the pending case of *Carpenter* was eagerly awaited.[245] There were some who argued that insider trading was a "victimless crime", that it moved the stock market in the "correct" direction, that prohibiting it was bad policy,[246] and that it was an appropriate way to compensate entrepreneurs and corporate management.[247]On the other hand, there was hope that the Supreme Court would affirm the misappropriation theory that Justice Burger had articulated in his dissent in *Chiarella*.[248] However the decision turned out to be anticlimactic since the Court affirmed the convictions under Rule 10b-5 due to the Court splitting 4:4 on this issue.[249] The 4:4 split was occasioned by the difficulty some Justices had in accepting that the fraud against the *Wall Street Journal*, namely misappropriating its printing schedule to "time" the trading, was "in connection with" a securities transaction.

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[241] 484 U.S. 19 (1987).

[242] Kenneth Felis, another participant in scheme, was also a broker at Kidder Peabody. Id. at 20-21.

[243] The story of the scheme is detailed in Winan's book, Trading Secrets: Seduction and Scandal at the Wall Street Journal (St. Martin's 1986). From reading the book, one could glean that the purpose was to punish Peter Brandt, an unscrupulous social climber, who was the chief prosecution witness against Winans and the other defendants. See *Broker in Winans Case to be Sentenced*, N.Y. TIMES, Feb. 27, 1988, at 37, 48..

[244] *Carpenter*, 484 U.S. at 23.

[245] *See, e.g.*, Stuart Taylor, Jr., *Winans Case Taken by Justices*, N.Y. TIMES, Dec. 16, 1986, at D1, D4; and James B. Stuart, *Death of a Theory? Supreme Court May Revamp Insider-Trading Law*, WALL ST. J., Sep. 30, 1987, at 1.

[246] Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 Cato J. 933, 935-937 (1985). For a later view of this thinking, see Donald J. Boudreaux, *Learning to Love Insider Trading*, WALL ST. J. Oct. 24, 2009, at W1.

[247] I offered to debate professor Manne on this point at his Law and Economics program at Dartmouth College. He declined. To rebute his position, consider *Diamond v. Oreamuno*, 248 N.E.2d 910 (1969), where two entrepreneurs, knowing that earnings would drop sharply because of a sharp increase in costs, sold 56,000 shares at $28; the market dropped to $11 when the adverse earnings were announced. Is this appropriate compensation?

Nor is insider trading victimless. The conceptual problem is that the injury is to the same side of the market. The person on the other side of the transaction actually benefits because, if buying, the sale by the insider drops the price, whereas, if selling, the purchase by the insider raises the price. But the person on the same side as the insider is always "late to the party." In *Oreamuno*, the insider got out at $28, whereas the public could only sell at $11. If disclosure were first made, the insider would need to compete with other sellers to get out as the market began to plunge. It is likely the an exchange would stop trading until the market digested the news and all would then have equal opportunity at the new price.

[248] See supra Part I.C.1.

[249] The Court unanimously affirmed the convictions under the mail and wire fraud statute. Carpenter v. U.S., 484 U.S. 19, 24 (1987).

It was not until ten years later that the Court upheld the misappropriation theory under Rule 10b-5 and affirmed the conviction of an attorney in a law firm that represented the bidder in a potential takeover.[250] Based upon his knowledge of the pending transaction, the attorney had purchased stock and call options of the target company. When the stock rose dramatically after the tender offer was announced, the attorney made more than $4.3 million.[251]

Justice Scalia dissented on the basis that section 10(b) requires the "manipulation or deception of a party to a securities transaction,"[252] while Justice Thomas, joined by Chief Justice Rehnquist, dissented on the basis that the majority opinion and the SEC failed "to provide a coherent and consistent interpretation" of the "in connection with" requirement.[253] In particular, they found inconsistent the position that a misappropriation of information would give rise to a Rule 10b-5 action, but a misappropriation of money would not.[254] The distinction drawn by the majority was that the fraud regarding information occurs when the information is wrongfully used, whereas the fraud in misappropriating money occurs at the time of embezzlement, irrespective of whether the money is later used to purchase securities.[255]

There is another weakness in the misappropriation theory that was recognized by the Second Circuit. Since Winans' fraud was converting the information of his employer as to printing schedules, the court observed that "the *Wall Street Journal* or its parent, Dow Jones Company, might perhaps lawfully disregard its own confidentiality policy by trading in the stock of companies to be discussed in forthcoming articles."[256] But the court felt assured that "a reputable newspaper, even if it could lawfully do so, would be unlikely to undermine its own valued asset, its reputation, which it surely would do by trading on the basis of its knowledge of forthcoming publications."[257]

That this would even be an issue illustrates absurdity of relying upon a common law duty to a person or entity that is not a party to a securities transaction to bring a lawsuit based upon, or "in connection with," a securities transaction. This in turn illustrates the absurdity in *Chiarella* of requiring a common law duty to the person on the other side of the transaction in order to establish deceit. How much more sensible would the law have been if *Chiarella* had truly followed *Cady, Roberts* and rejected reliance on common law principles, reframed "disclose or abstain" to "abstain until disclosable," and recognized that market professionals have such a duty when they knowingly [scienter] trade on material, non-public information.

II. The Fourth Trilogy: Insulating Collateral Participants from Liability

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[250] U.S. v. O'Hagan, 521 U.S. 642 (1997).
[251] *Id.* at 642.
[252] *Id*. at 679 (Scalia, J., dissenting).
[253] *Id*. at 680 (Thomas, J., dissenting).
[254] *Id*. at 683-684 (quoting the Government's argument at oral hearing).
[255] *Id*. at 655-657 (majority opinion).
[256] U.S. v. Carpenter, 791 F.2d 1024,1033 (2d Cir. 1986).
[257] *Id*.

The last trilogy of Supreme Court cases, dealing with the liability of collateral participants, is unique in that fourteen years passed between the first and second decisions; however, the second and third quickly followed each other. The Supreme Court saw its current decision, *Janus Capital Group, Inc.* as a necessary outcome if its decision in *Central Bank of Denver, N.A.*[258] were not to be undermined.[259] The Court in *Stoneridge Investment Partners, LLC* took essentially the same tack.[260] Since *Central Bank* is both significant in its own right, as well as essentially determinative of the subsequent two cases, it is important to understand upon what a shaky foundation it sits.

A. *Central Bank*: The Demise of Aiding and Abetting

At the outset, it is paradoxical, as well as disingenuous on the part of the Court, for a supposedly conservative court to engage in aggressive judicial activism. But this is exactly what the Court in *Central Bank* did. First, the issue decided by the Court was not the one litigated in the courts below, nor was it the issue raised by the parties on appeal. The issue below, and raised by the parties on appeal, dealt with the defendant's knowledge, or recklessness in not knowing, of the primary violation.[261] The parties never questioned the existence of a cause of action for aiding and abetting. Nevertheless, on its own motion, the Court directed the parties to brief this issue.

The next aspect of judicial activism was that all eleven circuits had accepted aiding and abetting liability.[262] When there is a split among the circuits, the Supreme Court often resolves it. But aiding and abetting liability was well settled law. As Justice Stevens pointed out in his dissent:

> *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

[258] 511 U.S. 164 (1994).
[259] 131 S.Ct. at 2302.
[260] 552 U.S. at 162-163.
[261] Cent. Bank of Denver v. First Interstate Bank of Denver, 508 U.S. 959 (1993). Grant of Certiorari limiting review to Question 2 presented by the petition and directing parties to brief and argue the following additional question "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 and SEC Rule 10b–5." *Id.*
[262] *See, e.g.*, Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793, 799–800 (3d Cir. 1978); Schatz v. Rosenberg, 943 F.2d 485, 496–497 (4th Cir. 1991); Fine v. American Solar King Corp., 919 F.2d 290, 300 (5th Cir. 1990); Moore v. Fenex, Inc., 809 F.2d 297, 303 (6th Cir. 1987), cert. denied sub nom. Moore v. Frost, 483 U.S. 1006, 107 S.Ct. 3231, 97 L.Ed.2d 737 (1987); K & S Partnership v. Continental Bank, N.A., 952 F.2d 971, 977 (8th Cir. 1991); Levine v. Diamanthuset, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991); Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992); Schneberger v. Wheeler, 859 F.2d 1477, 1480 (11th Cir. 1988). The only court not to have squarely recognized aiding and abetting in private § 10(b) actions has done so in an action brought by the SEC, see Dirks v. SEC, 681 F.2d 824, 844 (D.C. Cir. 1982), rev'd on other grounds, 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983), and has suggested that such a claim was available in private actions, see Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 35–36 (D.C. Cir. 1987). The Seventh Circuit's test differs markedly from the other Circuits' in that it requires that the aider and abettor "commit one of the 'manipulative or deceptive' acts prohibited under section 10(b) and rule 10b–5." Robin v. Arthur Young & Co., 915 F.2d 1120, 1123 (7th Cir. 1990).

> liability under § 10(b) and Rule 10b-5. . . While we have reserved decision on the legitimacy of the theory in two cases that did not present it, all 11 Courts of Appeals to have considered the question have recognized a private cause of action against aiders and abettors under § 10(b) and Rule 10b-5.[263]

Central Bank did not resolve unsettled law but rather unsettled very resolved law. While the majority stated that it "granted certiorari to resolve the continuing confusion over the existence . . . of the §10(b) aiding and abetting action," the only confusion as to its existence was in the mind of the majority.[264]

In the *Stoneridge Investment Partners* decision, the Court sought to justify its decision by asserting "[t]his is not a case where Congress has enacted a regulatory statute and then has accepted, over a long period of time, broad judicial authority to define substantive standards of conduct and liability."[265] But that was exactly what had occurred with respect to aiding and abetting liability. Section 10(b) was enacted in 1934, Rule 10b-5 was promulgated in 1940 and a private cause of action recognized in 1946, shortly after World War II ended.[266] Aiding and abetting liability was recognized at least as early as 1963,[267] and the Supreme Court first considered Rule 10b-5 in 1969.[268] Congress massively revised the 1934 Act in 1964[269] and again in 1975,[270] well aware of aiding and abetting liability. The doctrine itself has been recognized for a century,[271] and was formulated in the Restatement of Torts in 1939.[272]

Judicial activism could be accepted if it made sense from a policy standpoint or if it were supported by sound judicial reasoning. *Central Bank* met neither criterion. From a policy standpoint, the law should discourage wrongdoing, not insulate it from accountability. From a jurisprudential perspective, the *Central Bank* opinion is an embarrassment.

The Court began its analysis by recognizing that "Congress did not create a private §10(b)

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[263] *Central Bank*, 511 U.S. at192 (1994) (Stevens, J., dissenting).
[264] 511 U.S. at 170.).
[265] Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 163 (2008).
[266] *See supra* Part I.A.
[267] *See,e.g.*, Matter of Burley & Co., 23 SEC 461 (1946).
[268] *See supra* at note 36.
[269] Securities Acts Amendments of 1964. Pub. L. No. 467, 88th Cong., 2d Sess. (Aug. 20, 1964). These amendments expanded the reach of disclosure requirements under the 1934 Act, by making the registration, periodic reporting, proxy and insider trading provisions applicable to large over-the-counter companies in addition listed companies which were previously covered by the Act. The amendments also imposed increased standards and disciplinary controls for broker-dealers in securities. For a thorough analysis of the 1964 Amendments, *see* Richard M. Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 Duke L.J. 706 (1964).
[270] Securities Acts Amendments of 1975. Pub. L. No 29, 94th Cong. (June 4, 1975). These amendments further expanded the reach of the SEC to oversee self-regulatory organizations and develop a national system for clearance and settlement of securities transactions. They also expanded the reporting requirements of large financial institutions and generally sought to eliminate obstacles to competition within the securities industry. For a through analysis of the 1975 Amendments, *See* John G. Gillis, *Securities Law and Regulation: Securities Acts Amendments of 1975*, 31 Financial Analysts Journal 5 (Sep. – Oct., 1975), pp. 12-15.
[271] Cooley, Law of Torts 244 (3d ed 1906).
[272] §876(b).

cause of action and had no occasion to provide guidance about the elements of a private liability scheme."[273] However, with respect to the type of conduct prohibited, the statutory language controls. According to the Supreme Court, since the statutory language controls, this "bodes ill" for the existence of aiding and abetting liability since "Section 10(b) does not in terms mention aiding and abetting."[274] This is absurd reasoning. The Court acknowledged that the private cause of action was judicially created and thus Congress provided no guidance about its elements. Why then would any rational person expect Congress to deal with whether a remedy it did not create would be complemented by aiding and abetting liability for those who assist a primary violator?

Viewed from a different perspective, the argument can be made that Congress did anticipate aiding and abetting liability under Section 10. This section, by its terms, defines "unlawful" activity, and unlawful activity can be prosecuted criminally by the U.S. Attorney. The Crimes and Criminal Procedure section of the U.S. Code specifically provides:

> Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.[275]

There is also further statutory language that suggests that aiding and abetting liability does not affront the statutory scheme: Section 10b forbids conduct that "directly or indirectly" is "manipulative or deceptive."[276] The Court rebuts this argument by asserting that "federal courts have not relied on [this language] when imposing aiding and abetting liability.[277] This is because all federal courts prior to *Central Bank* did not find it necessary to construe the statute with regard to aiding and abetting liability since they were dealing with a judicially created cause of action. But, if you do look to the statute with an open mind, rather than an outcome determinative mindset, you find little basis for rejecting the cause of action.

The Court then asserts that Congress knew how to create aiding and abetting liability. Congress also knows how to pass a budget (or at least it did).[278] But Congress's knowledge of neither is relevant to a judicially created cause of action. The Court then concluded its analysis of the statute by asserting that the Court could not amend the statute by "creat[ing] liability for acts that are not themselves manipulative or deceptive."[279] In so doing, the Court fails to understand the difference between primary and secondary liability. It is the primary violator who engages in manipulative or deceptive conduct. The aider and abetter is secondarily liable

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[273] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173 (1994).
[274] *Id*. at 175.
[275] 18 U.S.C.A.§ 2(a).
[276] 15 U.S.C.A. §78j.
[277] *Central Bank*, 511 U.S. at 176.
[278] *See* Len Burman, *Budget brinkmanship in Congress must end*, The Christian Science Monitor, Dec. 18, 2011, http://www.csmonitor.com/Business/Tax-VOX/2011/1218/Budget-brinkmanship-in-Congress-must-end (explaining that Congress consistently followed a successful budget process beginning in 1974, but that in five of the past twelve years, Congress has not passed a budget resolution at all, instead relying on emergency measures and last-minute stop-gaps).
[279] *Central Bank*, 511 U.S. at 177-78..

because the person assists the primary violator. An essential element of aiding and abetting liability is that there must be a primary violation which would encompass manipulative or deceptive conduct.

After it completed its nonsensical examination of the statute to determine whether Congress provided for aiding and abetting liability with regard to a judicially created cause of action, the Court then fantasized whether, had Congress created a private cause of action, would it have provided for aiding and abetting. The Court examined the private causes of action that Congress expressly created and noted that none of them provided for aiding and abetting liability. The Court accordingly concluded that "[t]here is no reason to think that Congress would have attached aiding and abetting liability only to §10(b) and not to any of the express private rights of action in the Act."[280]

Unfortunately for the Court, there is a very significant reason to distinguish between section 10(b) and the express private rights in the 1933 and 1934 securities acts—a reason the Court itself created almost twenty years earlier. In *Ernst & Ernst*, the Court determined that the language of section 10(b) precluded a private action under Rule 10b-5 from sounding in negligence, thereby requiring scienter[281] -- today recklessness.[282] As the Court itself recognized, aiding and abetting liability originated in criminal law, [283] and its extension to negligence cases is of relatively recent origin.[284] Since the express private causes of action sound in negligence, it is not surprising that Congress did not attach aiding and abetting liability. But, in the express private causes of action, Congress did cast a broad net in terms of liability. For example, section 11 of the 1933 Act imposes liability, not just upon the issuer, but upon officers, directors, investment bankers and experts named in the registration statement.[285] In other circumstances, some of these named defendants could be considered aiders and abetters.

One of the private actions listed by the Court was section 9 of the 1934 Act.[286] Since liability is imposed on those who "willfully participate[]" in the proscribed manipulation, this is not a negligence provision. But it also does not negate a policy accepting aiding and abetting liability. While section 10 imposes liability upon those who "use or employ" manipulative or deceptive acts, section 9 imposes liability upon one who "willfully participates" in manipulation. The conduct of the suppliers in *Stoneridge Investment Partners*, who conspired with the issuer to inflate its earnings, was challenged on the basis that they directly participated in the fraud.[287]

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[280] *Id.* at 180.
[281] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
[282] *Id.* at 193 n 12. "In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." *Id.*
[283] 511 U.S. at 181.
[284] *Id.* at 181-182.
[285] 15 U.S.C. §77 k(a).
[286] 15 U.S.C. §78 i (e).
[287] 552 U.S. 148.

Section 9, by its terms, covers "willful" participants. Yet, on the basis of *Central Bank*, such liability was rejected even though the 1934 Act does not reflect a policy against liability for willful participants.

The Supreme Court, in *Central Bank*, also made short shrift of the argument that the 1984 and 1988 legislative reports approved of aiding and abetting liability under Rule 10b-5.[288] While the Court characterizes the Committee reports as making "oblique references" to aiding and abetting,[289] the references are hardly oblique. For example, the 1984 Report states "[t]he committee endorses the judicial application of the concept of aiding and abetting liability to achieve the remedial purposes of the securities laws."[290]

The Court also states that "the interpretation given by one Congress (or a committee . . . thereof) to an earlier statute is of little assistance in discerning the meaning of the statute."[291] But, paradoxically, this is in effect what the Supreme Court itself is doing. In the late 1970s, the Court began restricting the circumstances in which a private cause of action would be implied.[292] It then uses its recent antipathy toward private courses of action to restrict causes of action developed under an earlier Supreme Court regime in which the law at that time favored the implication of a remedy.

In *Central Bank*, the Court downplayed the fact that Congress had amended the securities laws many times without rejecting the judicial doctrine of aiding and abetting. But, previously with respect to Rule 10b-5, the Supreme Court had stated that "[t]he longstanding acceptance by the courts, coupled with Congress's failure to reject Birnbaum's reasonable interpretation . . . argues significantly in favor of acceptance of the Birnbaum rule by this Court."[293] Now, let's rewrite the prior sentence, substituting "aiding and abetting" for "Birnbaum": The longstanding acceptance by the courts, coupled with Congress's failure to reject *aiding and abetting*, argues significantly in favor of *aiding and abetting* liability. Or let's take the same tack to the Court's language in *Herman & MacLean*, substituting aiding and abetting for "Section 10(b)":

> In 1975, Congress enacted the "most substantial and significant of this country's Federal securities laws since the passage of the Securities Exchange Act in 1934 . . . ." When Congress acted, federal courts had consistently and routinely permitted a plaintiff to proceed *under aiding and abetting.* In light of this well

[288] 511 U.S. at 185 (citing H.R.Rep. No. 100–910, pp. 27 n 23 (1988) (noting that a certain provision did "not affect the availability of any other theories of liability, such as aiding and abetting …"; H.R.Rep. No. 98-355, p. 10 (1984) "Current law generally imposed secondary liability on persons who aid and abet the inside trader.".
[289] 511 U.S. at 185.
[290] 1984 U.S.C.C.A.N. 2283.
[291] 511 U.S. at 185.
[292] Cort v. Ash, 422 U.S. 66 (1975); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979); Cannon v. Univ. of Chicago, 441 U.S. 677 (1979); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216 (6th Cir. 1980) aff'd, 456 U.S. 353 (1982); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
[293] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975).

> established judicial interpretation, Congress's decision to leave *aiding and abetting intact* suggests that Congress ratified *aiding and abetting liability*.[294]

Apparently, the guiding principle for this Court is "a foolish consistency is the hobgoblin of little minds."[295] The opinion is an exemplar of justification, not analysis. As will be developed in the balance of this article, if there is a guiding principle for the Court in these cases, it is protecting corrupt businesses at the expense of the public investor.

B. *Stoneridge*: Direct Participant Liability

Central Bank was a classic case of aiding and abetting. The elements of aiding and abetting traditionally have been (i) a primary violation, (ii) knowledge of the primary violation or recklessness in not being aware of the primary violation by the secondary actor, and (iii) substantial assistance to the primary violator by the secondary actor.

In *Central Bank*, the primary violator was a real estate development that had issued bonds in 1986 and planned a new issue in 1988. The bond indenture required that the bonds be secured by real estate valued at 160% of the debentures. Capital Bank was the indenture trustee under both the existing and proposed bond offerings. Early in 1988, Central Bank secured a supposedly updated appraisal from the development's appraiser. The values were essentially unchanged from two years earlier, notwithstanding a drop in real estate prices in the Colorado Springs area and a number of foreclosures. The underwriter under the 1986 offering wrote to Central Bank, informed the Bank that the underwriter believed that the appraisal was inflated and that the indenture covenants were violated, and requested that Central Bank commission a new appraisal by an independent appraiser, as it had the authority to do under the indenture.[296] The Bank asked its own appraiser to examine the appraisal, and he also thought the appraisal was inflated. The Bank then met with the developer and agreed to postpone the new appraisal until after the 1988 offering. The new offering went forward and shortly thereafter the development company defaulted.[297]

The primary violation was the misrepresentations about the value of the real estate by the development company. Central Bank was charged with aiding and abetting, and the litigation revolved around the second element of aiding and abetting: Central Bank argued that it had no duty under the indenture to get a new appraisal and that, absent such a duty, recklessness was insufficient; without a duty, actual knowledge of the primary fraud was necessary.[298]

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[294] Herman & MacLean v. Huddleston, 459 U.S. 375, 384 (1983).
[295] Ralph Waldo Emerson, *Essays (First Series*), Page 21 (2007).
[296] First Interstate Bank of Denver, N.A. v. Pring, 969 F.2d 891, 894 (10th Cir. 1992) rev'd sub nom. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)
[297] *Id.* at 895,
[298] *Id.*at 900.

While it would be naive to say that Central Bank did not benefit from deferring the appraisal and letting the second offering go forward—it had both a stake in the fees from acting as trustee under the second offering and a stake in keeping a client happy to secure business in the future—it clearly was not a direct participant in the primary violator's fraud. Nonetheless, had it fulfilled its responsibilities and promptly obtained a new appraisal, the fraud on the investors probably would not have occurred.[299]

While it would be hard to label Central Bank as a crook, that is exactly what the defendants in Stoneridge were. And the Supreme Court was hardly unaware of the situation. It set out the facts as follows:

> For purposes of this proceeding, we take these facts, alleged by petitioner, to be true. Charter, a cable operator, engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cash flow. The fraud included misclassification of its customer base; delayed reporting of terminated customers; improper capitalization of costs that should have been shown as expenses; and manipulation of the company's billing cutoff dates to inflate reported revenues. In late 2000, Charter executives realized that, despite these efforts, the company would miss projected operating cash flow numbers by $15 to $20 million. To help meet the shortfall, Charter decided to alter its existing arrangements with respondents, Scientific-Atlanta and Motorola.
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> * * *
>
> Respondents supplied Charter with the digital cable converter (set top) boxes that Charter furnished to its customers. Charter arranged to overpay respondents $20 for each set top box it purchased until the end of the year, with the understanding that respondents would return the overpayment by purchasing advertising from Charter. The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepting accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers. Respondents agreed to the arrangement.
>
> In order that Arthur Anderson would not discover the link between Charter's increased payments for the boxes and the advertising purchases, the

[299] What the Supreme Court apparently does not understand is that it is engaging in risk allocation.

> companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business.[300]

Thus, Scientific-Atlanta and Motorola jointly conspired with Charter to engage in a series of transactions for the purpose of inflating earnings and thereby inflating the price of Charter's stock. Scientific-Atlantic and Motorola directly benefitted from the arrangement through increased revenues and profits and their direct participation in the fraud was essential to carrying out the fraud. With respect to the fraud, arguably they were primary violators, not secondary violators. The secondary characterization comes into play only because the purpose of the fraud was to inflate Charter's earnings and it was Charter that "made" the misrepresentation to the investing public about its earnings.[301]

Yet, the Court in *Stoneridge* blithely took the position that its decision was controlled by *Central Bank* and arguably extended it, stating: "The conduct of a secondary actor must satisfy each of the elements . . . for liability,[302] including reliance.[303] However, while the Court supposedly followed *Central Bank*, in which it had examined the express private causes of action to discern Congressional intent, an examination of the express liability provisions does not establish, or even support, the argument that the liability of secondary actors must meet all of the elements of liability for primary actors. The express liability provisions in the 1933 and 1934 Acts are complemented by liability imposed upon controlling persons who, in effect, are secondary actors. Section 15 of the 1933 Act [304] provides:

> Controlling Persons. Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 11 or 12 of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.[305]

Section 20a of the 1933 Act[306] provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable

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[300] Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 154. (2008).
[301] *See supra* Part II.C. Paragraph (b) of Rule 10b-5 makes it unlawful "To *make* any untrue statement of a material fact …" 17 C.F.R. § 240.10b–5(b) (emphasis added).
[302] 552 U.S. at 158
[303] *Id.* at 159.
[304] 15 U.S.C. §77o. (2011).
[305] *Id.*
[306] 15 U.S.C. § 78t (2011).

> jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.[307]

In none of these statutory secondary liability provisions is there any indication that, in order to hold the controlling person liable, a plaintiff must prove the same elements of a cause of action against the person secondarily liable as it does against the primary violator. Rather, Congress provided the direct opposite: plaintiff first must prove the cause of action against the primary violator and then the unique elements regarding the secondary violator's responsibility come into play.

From a standpoint of common sense, the opinion goes downhill from this point. Let's briefly go back to the facts. The defendants executed documents and engaged in transactions with the issuer, Charter Communications, the sole purpose of which was to inflate Charter's earnings—which was exactly what was accomplished.

With respect to this fraud, the Court made the following statements:

(i) Respondents' . . . deceptive acts were not communicated to the public;[308]

(ii) No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts; [309]

(iii) [There is no authority for a rule] that in an efficient market investors rely not only on the public statements relating to a security but also upon the transactions those statement reflect.[310]

(iv) [P]etitioner seeks to apply [§10(b)] beyond the securities markets - - to purchase and supply contracts -- the realm of ordinary business operations;[311]

(v) §10(b) . . . does not reach all commercial transactions that are fraudulent and affect the price of a security in some *attenuated* way.[312]

(vi) Here respondents were acting in concert with Charter in the *ordinary cause* as suppliers, and as matters involved in the not so ordinary course, as customers;[313]

(vii) Unconventional as the arrangement was, it took place in the marektplace for goods and services, not in the investment sphere.[314]

(viii) Charter was free to do as it chose in preparing its books [i.e. it wasn't compelled by respondents to cook its books].[315]

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[307] *Id.*
[308] Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 159 (2008).
[309] *Id.*
[310] *Id.* at 160.
[311] *Id.* at 161.
[312] *Id.* at 162 (emphasis added).
[313] *Id.* at 166 (emphasis added).
[314] 552 U.S. at 166.

The foregoing characterizations are nonsensical. Let's analyze these statements. First of all, the stock market is driven by earnings. Missing an earnings projection by a penny a share can send a stock plummeting.[316] To say that an investor relies on the earnings but not the transactions that underlie such earnings is sophistry. The reported earnings have no relevance absent the integrity of the underlying transactions. In WorldCom, for example, the earnings were fraudulent because cash outflows that should have been expensed were capitalized.[317] That was analogous to the fraud in the case at bar. Investors rely upon earnings as a surrogate for the integrity of the underlying transactions.

Moreover, this fraud did not affect the price of Charter stock *in some attenuated way*. As the Supreme Court expressly stated:

> Charter, a cable operator, engaged in a variety of fraudulent practices so its quarterly reports would meet Wall Street expectations for cable subscriber growth and operating cash flow . . . . Charter executives realized that despite these efforts, the company would miss projected operating cash flow numbers by $15 to $20 million. To help meet the shortfall, Charter decided to alter its existing arrangements with respondents, Scientific-Atlanta and Motorola.[318]

Rather than affecting the price of Charter stock in some attenuated way, the whole purpose of the fraud was to affect the price of the stock.

Finally, this fraud did not occur in the realm of ordinary business operations, the defendants were not in the ordinary course as suppliers, and the transactions did not take place in the marketplace for goods and services. Rather the fraud was the antithesis of ordinary business operations. In ordinary business operations, buyers do not pay double the market price for goods and advertisers do not buy advertisements they do not want. These transactions were not in the marketplace for goods and services, they were outside the marketplace and involved privately orchestrated corruption.

For the Supreme Court to classify the present fraud as an ordinary commercial transaction is beyond naive; the Court is consciously straining to present unconscionable activity as merely commercial. It is a little like Humpty-Dumpty in Through the Looking Glass: words mean exactly what I mean them to mean; neither more nor less.[319]

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[315] *Id.*

[316] *See e.g.*, *Oracle Profit, Revenue Miss Expectations; Shares Drop*, CNBC.com, Dec. 20, 2011 5:39 PM ET, available at http://www.cnbc.com/id/45736368 (Oracle reported its quarterly earnings were 54 cents per share, up from 51 cents per share for the previous year, but this was 3 cents per share lower than analysts expected, causing its stock to fall 14.6%.

[317] *See How to Hide $3.8 Billion in Expenses*, Bloomberg Businessweek, July 8, 2002, available at http://www.businessweek.com/magazine/content/02_27/b3790022.htm.

[318] 552 U.S. at 153.

[319] Lewis Carroll, *Through the Looking-Glass*, Thomas Y. Crowell & Co., 1893. P. 132.

C. *Janus Capital*: Who "Makes" a Misrepresentation

Just when you think Supreme Court jurisprudence cannot become any more absurd, the Court proceeds to outdo itself. A straight reading of *Janus Capital Group v. First Derivative Traders*[320] would suggest that the Court now has eliminated all management liability for securities fraud except for those members of management who sit on the board of directors. After *Janus Capital*, the new model for corporate governance should be a board composed only of one inside director, the CEO, and the balance of the board composed of outsiders who, if they are dumb enough, can escape liability for securities fraud. The rest of management need not worry.[321]

1. The Facts

Janus Capital involved a mutual fund, Janus Investment Fund (the "Fund") that stated in its prospectuses that it had taken steps to curb market timing,[322] when in fact it

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[320] 131 S.Ct. 2296 (2011).

[321] It is too early to determine how *Janus Capital* will play out. *See infra* text at notes 346-353. *But see* In re Merck & Co., Inc. Sec., Derivative, & ERISA Litig., 2011 WL 3444199, *24, *25 (D.N.J. Aug. 8, 2011). In *Merck*, plaintiffs alleged that Merck overstated the commercial viability of its top-selling drug Vioxx. *Id.* at *1. Several of the individual defendants, all officers of Merck, raised defenses based *Janus*, arguing that the statements attributed to them cannot lead to liability because the defendants did not have "ultimate authority over the statement[s]." Id., at *24, (quoting *Janus*, 131 S.Ct. at 2302). The District Court used agency concepts to differentiate, arguing that Management in Janus was a separate entity from the Fund, meaning it was not an agent of the Fund. *Id.* In *Merck*, the officers were agents of Merck. *Id.* Because corporations can only act through agents, it would be unreasonable to absolve corporate officers of primary liability for all 10b-5 claims just because the statements they make are ultimately within control of the corporation which employs them. Id. *See also* Monk v. Johnson & Johnson, 2011 WL 6339824, *17 n19 (D.N.J. Dec. 19, 2011) (defendants raised claims almost identical to those in *Merck*, and the District Court used the same analysis from *Merck* to refute them).

[322] *See. e.g.*, Gary D. Halbert, *The Hedge Fund/Mutual Fund Scandal*, PROFUTURES INVESTMENTS, *available at* http://www.profutures.com/article.php/206/, who described the market timing scandal as follows:

> Canary [Capital Partners LLC] (and perhaps other large hedge funds) allegedly obtained special trading opportunities with several leading mutual fund families - reportedly including Bank of America's Nations Funds, Banc One, Janus and Strong - by promising to make substantial investments in various mutual funds offered by these firms.
>
> The special trading opportunities, in this case fraudulent trading opportunities, consisted primarily of so-called "late trading" of mutual funds after the stock markets close at 4:00 eastern time. If you or I, for example, want to make a purchase or sale of a mutual fund, we have to get our orders in to the fund family before the close of the markets, sometimes 30 minutes or more before the markets close. If you or I place our order after the markets close at 4:00 today, then we don't get that order filled until tomorrow at the 4:00 closing price.
>
> In the case of Canary, the mutual funds noted above (and possibly others) allegedly allowed Canary (and others) to place its orders AFTER the markets closed and still get the closing price for the same day. As you know, there are frequently announcements just after the markets close that can have significant effects on the markets the following day. Allegedly, these hedge funds would trade on this after-market information and reap big profits the following day.

had not. Janus Capital Group ("Janus Capital") is a publicly traded asset management company that created the Fund as a separate legal entity owned by the Fund's shareholders. Janus Capital Management LLC ("Management") is a wholly owned entity controlled by Janus Capital, which was engaged by the Fund to be its investment advisor.[323]

The investment advisory services provided by Management included "management and administrative services necessary for the operation of the [Fund]"[324] All the officers of the Fund were officers of management; one member of the Fund's board of directors was associated with Management.[325]

Plaintiffs alleged that Janus Capital and Management caused the Fund to issue prospectuses which created a misleading impression that Janus Capital and Management would implement measures to curb market timing in the Fund. The District Court dismissed the complaint, but the Fourth Circuit reversed on the basis that "JCG [Janus Capital] and JCM [Management], by participating in the writing and dissemination of the prospectuses, *made* the misleading statements contained in the documents."[326] With respect to reliance, the Fourth Circuit also determined that investors would infer that Management "played a role in preparing or approving the contents of the Janus fund prospectuses," but would not infer the same about Janus Capital, "which could be liable only as a 'control person.'"[327]

To this, the Supreme Court simply responded that, to be liable, "JCM [Management] must have 'made' the material misstatements in the prospectuses. We hold that it did not."[328]

2. The Flawed Analysis of the Majority

The policy perspective from which the majority began its analysis is (i) contrary to the philosophy that formerly covered interpretation of the securities laws, namely, "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry" and to construe legislation enacted to avoid fraudulent activity "not technically and restrictively, but flexibly to effectuate its remedial purposes,"[329] (ii) contrary to Congressional policy in enacting the 1934 Act "to insure the

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Allowing large hedge funds to trade after hours is illegal and it serves to reduce profits and/or increase losses to the other shareholders of the mutual funds!

[323] *Janus,* 131 S.Ct. at 2299.
[324] *Id.*
[325] *Id.* The opinion pointed out that the Fund's board was more independent than required by the securities laws: "Up to 60 percent of the board of a mutual fund may be composed of 'interested persons.'" *Id.* (citing 15 U.S.C. §80a-10(a)).
[326] Janus Capital Group, Inc. v. First Derivative Traders, 131 S.Ct. 2296, 2301 (2011) (*citing In Re Mutual Funds Investors Litigation*, 566 F. 3d 111, 121 (2009) (emphasis in original).
[327] *Id.* at 2301 (*citing In Re Mutual Funds Investors Litigation*, 566 F. 3d at 127, 128,129-130.).
[328] *Id.*
[329] SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186, 195 (1963).

maintenance of fair and honest markets,"[330] and (iii) contrary to the policy of section 10 of that Act to further the public interest and to protect investors.[331] According to the majority, "[c]oncerns with the judicial creation of a private cause of action caution against its expansion," and thus the Court must give "narrow dimensions" to a private cause of action Under Rule 10b-5.[332]

After engaging in some wordsmithing, the majority determined that "the maker of the statement is the person or entity with ultimate authority over the statement, including its contents and whether and how to communicate it."[333] According to the Court, a broader reading of "make" would "substantially undermine *Central Bank*" because, "if persons or entities without control over the contents of the statement could be considered primary violators who 'made' the statement, then aiders and abettors would be almost nonexistent."[334]

The problem with this statement of the Court, is that it is dead wrong,as indicated by the cases it was seeking to preserve and felt compelled to follow and protect. *Central Bank*[335] dealt with an aider and abettor bank that failed to follow up on information that the land, which secured the debentures of which it was a trustee and which was the subject of a forthcoming offering, was substantially overvalued, while *Stoneridge*[336] dealt with businesses that conspired with the issuer to manipulate the prices each charged the other in order to inflate the issuer's earnings. In none of these cases was there any assertion that the aiders and abettors and co-conspirators *made* any statement.

In the case at bar, the majority rejected the idea that Management could have "made" the statement in the Fund's prospectus. The Court asserted that only the person with ultimate authority can "make" a statement and that attribution is strong evidence as to who is the maker.[337] In so doing, the majority used the analogy of a speechwriter and a speaker.[338] While the speechwriter may draft a speech, it is the speaker who is responsible for the content.

But in this case, respondent's analogy may be more apt: that of a playwright and the actor.[339] While the actor speaks, it is the playwright who is responsible for the statements.

The majority emphasized that the Fund had an independent board of directors.[340] Thus, the board would be responsible for the misstatements in the prospectuses. But the Fund does not

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[330] Securities Exchange Act of 1934, 15 U.S.C. § 78b (2010)
[331] Securities Exchange Act of 1934, 15 U.S.C. § 78i (2010)
[332] Janus Capital Group, Inc. v. First Derivative Traders, 131 S.Ct. 2296, 2302 (2011).
[333] *Id.*
[334] *Id.*
[335] *Discussed supra* text at note 264
[336] *Discussed supra* text at note 300
[337] *Janus*, 131 S. Ct. at 2302.
[338] Janus Capital Group, Inc. v. First Derivative Traders, 131 S.Ct. 2296, 2302 (2011)
[339] *Id.* at 2304.
[340] *Id.*

have its own employees.[341] The Fund's board is dependent upon Management for information and advice. She who controls the information, controls the decision.[342] This reality is beyond the ken of the majority. It concludes that, even though Management "was significantly involved in preparing the prospectuses," since Management was "subject to the ultimate control" of the Fund, the Fund and not Management "made" the statements in the prospectuses,[343] even though the board may not have had any knowledge that the statements in the prospectus were false and misleading.

This stance by the majority is even more irrational since the false statements related to matters, namely, whether market timing had been stopped, which were totally in the control of Management, which drafted the prospectuses. You can rest assured that Management did not tell the board of the Fund that it continued to permit market timing, and that it would also be asserting the contrary in the prospectuses.

The Court also relied upon the *Stoneridge* holding that the public could not have relied upon the actions of Motorola and Scientific-Atlanta in conspiring with Charter Communications to inflate the latter sales, which thus inflated Charter Communications' earnings and stock price, because "it was not inevitable" that the company would use the increased sales to increase its earnings.[344] At the risk of wordsmithing like the majority, it depends upon what the word "inevitable" means. Of course it is possible that Charter Communications' management might have had a conversion experience, realized the evil of inflating earnings, and reversed the inflated sales data. But is not the likelihood of this so remote that any rational person would conclude that the pattern of inflated sales would "inevitably" be incorporated into the financial statements? As indicated above, the thinking process of the majority is either outcome determinative or Alice in Wonderland. To suggest that management would orchestrate an elaborate series of fraudulent transactions, but then not "inevitably" incorporate them into the public financial statements, is again irrational.

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[341] *See* "Facts," *supra* text at note ___.

[342] This conclusion is based upon my experience as an expert in mutual fund litigation. Basically, the board does what the manager recommends. Portions of my opinion were quoted extensively by the Eighth Circuit in reversing the District Court in Gallus v. Ameriprise (the American Express mutual fund advisor), 561 F.3d 816 (8th Cir. 2009). This experience is confirmed by the administrative proceedings in connection with the Janus Group market timing. *See in re Lammert, Soderberg & Newcomb,* Initial Decision Rel. No. 348, at 25, *available at* http://www.sec.gov/litigation/aljdec/2008/id348cff.pdf, where the administrative law judge stated:

> The existence of approved market timing relationships was widely known no later than the completion of the Beery Report, which was circulated to dozens of Janus employees and executives. This knowledge was never shared with the Board. In the presentation to the Board on the use of redemption fees on market timing the legal department relied heavily on the Beery Report in the preparation of materials for the presentation. However, the final materials provided to the Board did not include any mention of the approved market timing relationships.

[343] *Janus*, 131 S.Ct. at 2302.

[344] *Id.* at 2303.

Yet, the majority uses this twisted logic from *Stoneridge* to support its reasoning in *Janus Capital* that only the person with ultimate control over the statement and its communication can "make" a statement because "without such authority, it is not 'necessary or inevitable' that any falsehood will be contained in the statement."[345] Again, refer back to the prior discussion. It was in the best interests of Janus Capital not to disclose that it had not terminated market timing. Janus Capital, through Management, controlled the drafting of the prospectus. Would any rational person expect Janus Capital to either disclose in the prospectuses that it had continued this illegal activity or to disclose to the board of directors that it was denying the continuation of this activity in the prospectuses, even though it had not been terminated? The board, and thus the Fund, were at the mercy of Management. Clearly the statements were "made" by Management. But, since Management did not make the statement, according to the Court, it is not liable, nor is its control person, Janus Capital. And the board of directors is not liable because they lacked scienter as to the misleading nature of the prospectuses.

Once again, the Supreme Court provides a safe harbor for fraudulent activity.

The minority took the majority to task, not only for the Court's unwarranted reliance upon *Central Bank* and *Stoneridge*,[346] but, more importantly, for its uncalled wordsmithing with regard to the scope of the word "make." The dissent asserted:

> But where can the majority find legal support for the rule that it enunciates? The English language does not impose upon the word "make" boundaries of the kind the majority finds determinative. Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have "ultimate authority" to control.[347]

Whether this will be the case in the future is discussed below.

3. The Consequences of the Court's Decision

Arguably, the Supreme Court has written the script for the perfect crime. According to the administrative law judge in the disciplinary proceedings with respect to market timing by the Janus Group, the Board of Directors was not informed of the market timing activities.[348] If only the Board of Directors is deemed to make the statement because of its ultimate authority, and if the board is unaware of the truth, then there is no primary violation, which would also mean that, even in an SEC proceeding, there could be no aiding and abetting liability because of the lack of a primary violation.

Under the law prior to *Janus Capital*, as the dissent pointed out:

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[345] Janus Capital Group, Inc. v. First Derivative Traders, 131 S.Ct. 2296, 2303 (2011)
[346] *Id.*. at 2307-2309 (Breyer, J., dissenting).
[347] *Id.* at 2307.
[348] *See Lammert* opinion, *supra* note 342: "However, the final materials provided to the Board did not include any mention of the approved market timing relationships."

> [B]oth language and case law indicate that, depending upon the circumstances, a management company, a board of trustees, individual company officers, or others, separately or together, might "make" statements contained in a firm's prospectus—even if a board of directors has ultimate content-related responsibility.[349]

For example, the Supreme Court, in 1983, in the process of determining that an express private cause of action under the 1933 Act did not exclude an implied cause of action under rule 10b-5, stated:

> If, as Herman & MacLean argues purchasers in registered offerings were required to rely solely on Section 11, they would have no recourse against such individuals even if the excluded parties engaged in fraudulent conduct while participating in the registration statement. The exempted individuals would be immune from federal liability for fraudulent conduct even though Section 10(b) extends to "any person" who engages in fraud in connection with a purchase or sale of securities.[350]

The Supreme Court's approach in *Janus Capital* would also seem to make its warning in *Central Bank* that "[a]ny 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,"[351] illusory. Arguably, *Central Bank*, by eliminating aiding and abetting liability, reduced the likelihood that attorneys would act as gatekeepers in preventing their clients from making fraudulent representations.

The idea that a lawyer, in drafting documents in connection with a securities transaction, can be held liable as a primary violator for co-authoring or co-creating the document was first developed in *Klein v. Boyd*,[352] a case that was later settled on appeal and the opinion withdrawn. This was further developed in *In re Enron Securities, Derivative, and ERISA Litigation*,[353] where

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[349] *Janus*, 131 S.Ct. at 2306.
[350] *Herman & MacLean v. Huddleson*, 459 U.S. 375, 387, n. 22(1983).
[351] 511 U.S. 164, 191 (1994).
[352] Klein v, Boyd, 949 F.Supp. 280 (E.D.Pa.1996), *aff'd*, —— F.3d ——, 1998 WL 55245, Fed. Sec. L. Rep. P 90,136 (3d Cir.1998), *rehearing en banc granted, judgment vacated* (Mar. 9, 1998).
[353] The District Court, in *In re Enron Securities, Derivative, and ERISA Litigation*, 235 F. Supp. 2d 549, 586 (S.D. Tex. 2002), summarized*Klein* as follows:

> In *Klein v. Boyd*, a panel of the Third Circuit Court of Appeals found that the law firm in the dispute could be liable as a primary violator of securities fraud even though the attorney did not sign the documents and was never known to the investor as a participant in the documents' creation. The appellate court concluded that once the law firm "elected to speak" by creating or participating in the creation of the documents it could not make material misrepresentations or omit material facts in drafting non-confidential documents such as opinion letters. Fed. Sec. L. Rep. (CCH) ¶ 90,136, 90,323 (3d Cir.1998) (citing and quoting from its earlier opinion, Kline v. First W. Gov't Sec., Inc., 24 F.3d 480, 490–91 (3rd Cir.1994)). The law firm's duty did "not arise from a fiduciary duty to the investors; rather, the duty arose when the law firm undertook the affirmative act of communicating with investors . . . " *Id.* at 90,323–24. Thus the court concluded that although the firm may not have a duty to blow the whistle on its client, once it chooses to speak, a law firm does have a duty to speak truthfully, to make accurate or correct material statements, even though the document may not be facially attributed to the lawyer. Id. at 90,325. The panel did require that the lawyer's "participation in the statement containing a misrepresentation or omission of a material fact [be]

the court held that the law firm of Vinson and Elkins, which drafted prospectuses and various SEC filings with knowledge that Enron had used a variety of special purpose entities to inflate its income, could be primarily liable as an author or co-creator of the documents, even though the documents were distributed and filed under the name of Enron, while Kirkland and Ellis, which represented some of the special purpose entities, would not be liable since it engaged only in "transaction" work and made no misrepresentation to investors.

Cases such as the foregoing, which required that a lawyer be a counselor and not just a hired gun, are now eviscerated by the Supreme Court's decision in *Janus Capital*.

CONCLUSION

The evolution of Supreme Court jurisprudence over the past forty years reflects a sea change in judicial philosophy. At the start of the 1970s, the liberal trend characterized by the Warren Court still prevailed. An implied private cause of action was still in favor and litigators were viewed as private attorneys general,[354] enforcing the securities laws to further the policy of protecting investors. Arguably, judicial over-exuberance led to some loose reasoning in cases such as *Superintendent of Insurance* and *Affiliated Ute*.

The expansion of Rule 10b-5 was slowed and more judicial discipline injected by the Burger Court in the mid-1970s. A trilogy of well-reasoned conservative decisions put Rule 10b-5 jurisprudence in a proper perspective: plaintiffs needed to be buyers or sellers to have standing, scienter was required to distinguish the implied cause of action from the express remedies in the securities acts, and deception was the touchstone for an action predicated upon a statute giving the SEC the authority to prohibit only manipulative or deception conduct.

The Rehnquist Court in the 1980s began a naive and reactionary trend – ignoring fraudulent conduct in order to further circumscribe the reach of Rule 10b-5. Although the securities laws were enacted because the common law was inadequate, the Court, in *Chiarella*, introduced the common law concept of fiduciary duty to curtail the application of the securities laws, while citing authority that took a diametrically opposed interpretation. This was the

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sufficiently significant that the statement can properly be attributed to the person as its author or co-author," so that it would not fall within the parameter of conduct constituting aiding and abetting.

[354] *See, e.g.* J.I. Case v. Borak, 377 U.S. 426, 432 (1964) ("Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements.").

beginning of outcome determinative analysis which was expanded in *Dirks* to add a naïve quality, when the Court ignored the S.E.C's warning that some excuse could always be fabricated[355] to evade the test for liability formulated by the *Dirk's* majority.

The final trilogy began with the Rehnquist Court and ended with the Roberts Court. Conservative jurisprudence has now been abandoned and the Court uses one ill-reasoned decision to awkwardly justify an even more ill-reasoned decision. *Central Bank* was the epitome of judicial activism. The court instructed the parties to brief an issue that had not been considered in the courts below nor raised by the parties on appeal; the Court rejected the unanimous position of all the judicial circuit courts that aiding and abetting liability did attach to a primary violation under Rule 10b-5; the Court ignored statutory language and legislative history that dictated a contrary result; and the Court relied upon the lack of aiding and abetting provisions with respect to express private causes of action sounding in negligence to justify the elimination of aiding and abetting liability under Rule10b-5, which requires scienter – ignoring the fact that aiding and abetting liability traditionally had not been applicable with respect to negligence actions.

In the *Stoneridge* and *Janus Capital* cases, the Court then strained to contort these cases as being controlled by *Central Bank*, even though they involved direct participation in the fraud, rather than aiding and abetting liability. It then articulated an absurd interpretation of the word "make" in *Janus Capital* to exculpate the person who not only drafted the document but also controlled the "facts" in the document that made it misleading.

Since the 1980's, the fact is inescapable that the Supreme Court, confronting activity that it acknowledged as fraudulent,[356] has engaged in tortuous, outcome-deterministic reasoning to create, in effect, safe harbors for fraudulent activity. In so doing, the Court reflects, not a conservative philosophy, but a reactionary one. Its advocacy for conduct that in some instances could be criminal stands in stark contrast to the Warren Court. The Warren Court sought to

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[355] *See* Dirks v. S.E.C., 463 U.S. 646, 663 (1983):

> The SEC argues that, if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. We think the SEC is unduly concerned.

[356] Arguably, this is not true of the defendant in Dirks: the majority saw him as a hero even though he personally profited by enabling his clients to dump stock and depress the market, to the detriment of uninformed public investors.

protect the uninformed from the power of the State; the Roberts Court appears to protect the powerful from the investing public.

While correlation is not causation, it is noteworthy that a rash of insider trading followed the insider trading trilogy, and that the corporate corruption scandals[357] of the 2000s followed *Central Bank* and PLSRA.[358] The impact of the insider trading cases has been dampened by the enactment of ITSA and ITSFEA,[359] and the reluctant acceptance of the misappropriation theory by the Supreme Court in *O'Hagan*.[360] On the other hand, the Court's ill-advised emasculation of liability for collateral participants needs to be reversed legislatively. Congress went part way when it reinstated aiding and abetting liability in actions brought by the SEC. It now needs to complete this effort by extending aiding and abetting liability to private litigation. By reversing *Central Bank*, it will also take down *Stoneridge* and *Janus Capital*, and close the judicially created loopholes that have enabled corrupt actors to act with impunity and avoid accountability.

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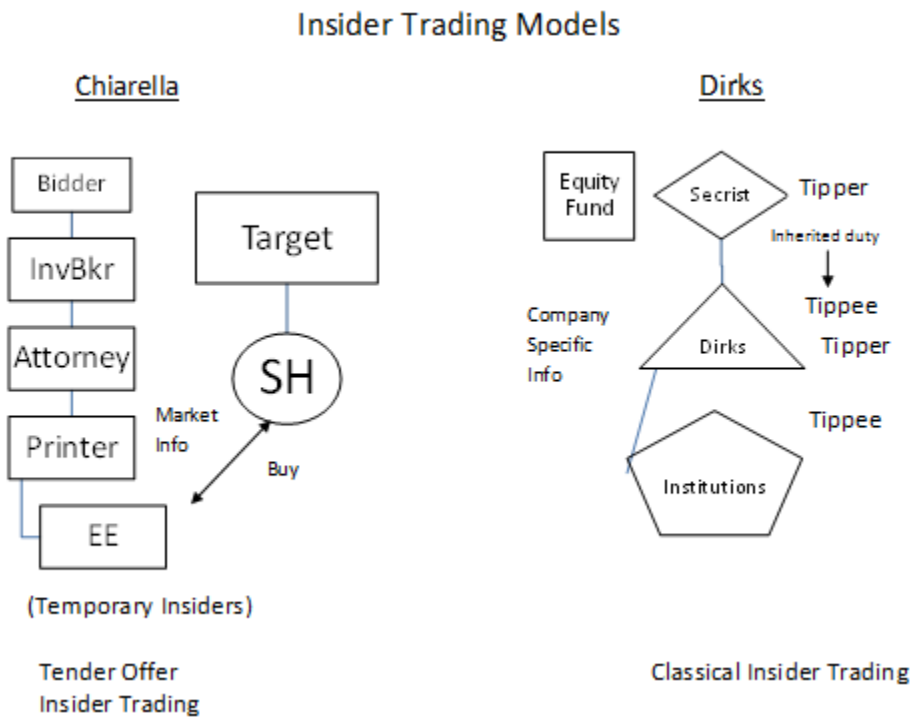
[357] *See* HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE App'x D (West 2006-2007) (listing over twenty of the more spectacular examples of corporate corruption during this period).
[358] *See, e.g.,* 15 U.S.C.A. § 78u-5(c)(1)(the effect of this provision is to exculpate a person who, with knowledge, makes a fraudulent forward-looking statement, if the statement is accompanied with cautionary language.
[359] *See supra* text at note 232-233for discussion of the impact of these legislative enactments.
[360] Chief Justice Rehnquist and Justices Scalia and Thomas dissented from the Court's acceptance of the misappropriation theory.

Exhibit A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