No. 06-1341

IN THE

Supreme Court of the United States

THE REGENTS OF THE UNIVERSITY OF CALIFORNIA,
Petitioner,

v.

MERRILL LYNCH PIERCE FENNER & SMITH, INC.; MERRILL LYNCH & COMPANY, INC.; CREDIT SUISSE FIRST BOSTON (USA), INC.; CREDIT SUISSE FIRST BOSTON LLC; PERSHING LLC; BARCLAYS PLC; BARCLAYS BANK PLC; BARCLAYS CAPITAL, INC.
Respondents.

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

PETITIONER'S REPLY TO BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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Petitioner agrees that *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, No. 06-43, presents the legal issue of civil liability under §10(b) and Rule 10b-5 for engaging in a scheme to defraud investors. Indeed, *Stoneridge* presents the issue of whether an actor whose *conduct* violates the prohibitions of §10(b)/Rule 10b-5 forbidding "any person . . . to use or employ . . . any . . . deceptive device or contrivance," *i.e.*, "any device [or] scheme . . . to defraud . . . or to engage in any act [or] practice . . . which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security," can be held liable even if that actor itself does not make a false statement to investors.

However, Petitioner respectfully disagrees that *Stoneridge* is a superior vehicle for the Court to decide this scheme or conduct liability issue. *Enron* is the most notorious financial scheme of the age, receiving unrivaled attention in financial, political, and legal circles. While this Court does not sit as a court of last resort for all important cases, it is undeniable that the *Enron* case is the most prominent and consequential of modern financial frauds. Perversely, it was because of the very egregiousness of that fraud that the victims' situation became so desperate, and they faced the prospect of no recovery under the very federal laws meant to protect them. The company went bankrupt, barring any recovery from Enron. The insurance coverage of the officers and directors was impaired by the deliberate-and-dishonest-acts exclusion and was significantly consumed by defense fees which reduced its coverage limits. Government seizures of the assets of Enron insiders arising from 34 criminal convictions deprived the Enron victims of access to those actors' assets. Enron's auditors' conviction (later reversed) for destroying evidence effectively put the accounting firm out of business. Enron's lawyers' assets and insurance coverage were tiny compared to the victims' damages. Thus, the only hope for any real recovery was from the Bank Defendants, who were intimately involved in executing the fraud, who profited from it, and whose misconduct Petitioner believed fell well within the text of §10(b)'s/Rule 10b-5's prohibition against devices, contrivances, acts, practices, or schemes to defraud purchasers of securities.

The Bank Defendants, whose liability is in issue, are the very actors whose misconduct involving public companies and our securities markets led to the stock-market Crash of 1929 and was a primary motivation for enacting our federal securities laws — laws meant to regulate investment banks' behavior in interacting with public companies and investors, and thus to protect those who put their capital to work in our public markets from fraudulent misconduct. They are also the very actors that *Central Bank N.A. v. First Interstate Bank N.A.*, 511 U.S. 164 (1994), explicitly made clear could remain liable in any large and complex securities fraud, whenever their actions may be alleged and proven to violate the prohibitions of §10(b)/Rule 10b-5.

The Bank Defendants' intimate and extensive involvement in the Enron fraud — detailed by government investigations, bankruptcy court examiner reports and by extensive discovery in the civil class-action case — epitomizes the kind of deceptive misconduct financial institutions are occasionally capable of, and the tremendous damage that kind of conduct can inflict on innocent investors, including individual investors, public pension funds, and Taft-Hartley pension funds. The *Enron* case is the best vehicle to review and resolve the scheme/conduct liability issue because the exceptionally welldeveloped factual record in this case demonstrates the Bank Defendants' use of contrivances and deceptive conduct. After all, the case had been prepared for five years, was at summary judgment, and just weeks away from trial, when it was stopped.

The Bank Defendants that allegedly engaged in deceptive conduct as part of the scheme to defraud Enron's investors — *i.e.*, who engaged in acts and practices that operated as a fraud on Enron's investors — were financial-market sophisticates. Their involvement with Enron was not isolated, sporadic or limited to a few commercial transactions later misaccounted for. Rather, they repeatedly contrived and executed sham transactions to falsify the public company's financial results. Here the Bank Defendants were, as Petitioner noted originally, "full-service schemers." For years, they repeatedly and deliberately engaged in contrived and deceptive financial-statement (*i.e.*, "structured finance") transactions specifically intended to cook Enron's books — to hide Enron's debt and falsify its financial results and financial condition — as reported to credit-rating agencies, investors and the markets; all the while lying to Enron's auditors to conceal the deceptive and bogus nature of those contrived transactions. At the same time, they also sold billions of dollars of Enron's securities (and those of Enron-related entities) via offering circulars and registration statements which contained those falsified financial statements. In so doing, they garnered huge fees for themselves while raising for Enron the cash that was indispensable to keep the whole Enron Ponzi scheme going — so that they (and others) could continue to profit from that ongoing scheme, which they hoped might continue indefinitely. Finally, these Bank Defendants also issued false analyst reports on Enron to boost its stock price — reports which trumpeted Enron's bogus financial statements and financial condition, presenting a false picture of Enron's business and the risks that investors were taking in investing in that purportedly solvent, safe, and thriving enterprise.

Merrill Lynch even fired its Enron analyst at one point when he dared break from the party line to mutter even the slightest negative information. USCA5 7473-78.[1]

So these Bank Defendants were neither normal commercial counter-parties in ordinary-course-of-business transactions, nor silent observers of a fraudulent scheme involving others. They *acted* deceitfully and they *spoke* falsely. Assuming the other elements of §10(b)/Rule 10b-5 are satisfied, if their conduct does not render them liable under §10(b)/Rule 10b-5 to the victims of this fraud, then the broad anti-fraud provision of our nation's securities laws has a huge, gaping hole in it, which will operate to encourage this type of harmful conduct going forward — damaging both victimized investors, as well as our economy and financial markets.

Petitioner believes that it is vital that the Court have in mind the circumstances of the Enron fraud in deciding the scheme/conduct liability issue admittedly presented by the *Stoneridge* case. This can be achieved by granting certiorari in this case or, alternatively, by being ever mindful that the result in *Stoneridge* will dictate the result in *Enron* – and the fate of the victims of that fraud.

II. THE FIFTH CIRCUIT'S CLASS-CERTIFICATION DENIAL WAS BASED ON ITS RULING THAT SCHEME LIABILITY DOES NOT EXIST UNDER §10(b)/RULE 10b-5

It is technically accurate to state that the Fifth Circuit decision for which review is sought was rendered in a Federal Rule of Civil Procedure 23(f) class-certification appeal. However, the undeniable basis of the decision was the ruling that *as a matter of substantive law* under §10(b)/Rule 10b-5 the Bank Defendants could not be held liable for engaging in the scheme to defraud Enron's investors, *i.e.*, their deceitful

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[1] "USCA5" refers to the page numbers in the Fifth Circuit Record on Appeal.

conduct was beyond the statute's reach. In the panel majority's view, the underlying legal merits of plaintiffs' claim was an issue that overlapped with the class-certification issue. In this regard, the Fifth Circuit panel majority's decision speaks for itself.

Whether the Fifth Circuit panel majority *should have* reached this substantive legal issue in the context of a Rule 23(f) procedural appeal is beside the point. It did. And the majority's apparent eagerness to do away with scheme liability is fatal to fraud claims asserted by Enron fraud victims.

Respondents say review would be complicated because this Court would have to reach class-certification issues that the Fifth Circuit did not. But that is pure nonsense. This Court will decide the Question Presented, and remand for further proceedings. It will not have to decide other issues that Respondents perhaps advanced below, but that the Fifth Circuit did not even consider.

To deny the victims of the Enron fraud the ability to have the validity of their underlying substantive legal theory reviewed by this Court, because the Fifth Circuit panel majority ruled against the merits of their claims in an interlocutory class-certification appeal, heaps one injustice on top of another. It is one more reason why the panel majority's decision, by its own admission, does not seem to comport "with notions of justice and fair play" to the "former Enron shareholders who have lost billions of dollars in a fraud." Appx. at 31a.[2]

At bottom, the panel majority ruled the way it did because it said the plaintiffs' theory of liability under §10(b) was no good. That ruling is wrong. The *Enron* plaintiffs have a valid claim under §10(b)/Rule 10b-5 as the district court had repeatedly ruled, supported by the SEC's *amicus* submissions

[2] "Appx." refers to the Appendix filed with the Petition for Writ of Certiorari filed on April 5, 2007.

in *Enron* and other cases, and as the Ninth Circuit recognized in *Simpson,* which itself cited the *Enron* district court's ruling with approval. *See Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1050 (9th Cir. 2006) (citing with approval *In re Enron Corp. Sec. Litig.*, 310 F. Supp. 2d 819, 830 (S.D. Tex. 2004), and *In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 580 (S.D. Tex. 2002)). Petitioner should be permitted to pursue that valid legal claim to trial, if the case can survive the summary-judgment motions which were pending and about to be decided by the district court when the Fifth Circuit panel majority brought the class-action case to an end.[3]

III. RESPONDENTS' SUBSTANTIVE ARGUMENTS REGARDING SCHEME OR CONDUCT LIABILITY MERELY CONFIRM THE NEED FOR THIS COURT TO RESOLVE THE ISSUE

Rule 10b-5 makes it unlawful for "any person, directly or indirectly," "(a) [t]o employ any device, scheme or artifice to defraud" and "(c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. §240.10b-5(a) and (c). Respondents nevertheless argue in their opposition that there is no scheme/conduct liability under §10(b)/Rule 10b-5, as *Central Bank* established an inviolate legal barrier protecting banks from such liability no matter how intentional, contrived, deceitful and damaging their conduct. Yet *Central Bank* was clear that it did not immunize Wall Street banks from liability for engaging in complex securities frauds. It specifically identified banks as it recognized: "The absence

[3] Following the plain text of the statute, the SEC's longstanding recognition of scheme and conduct liability in Rule 10b-5(a) and (c) is entitled to deference. *See SEC v. Zandford*, 535 U.S. 813 819-20 (2002) (SEC's interpretation of §10(b) "is entitled to deference if it is reasonable"); *Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979).

of §10(b) aiding and abetting liability *does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. . . . In any complex securities fraud, moreover, there are likely to be multiple violators* . . . ." *Central Bank*, 511 U.S. at 191.[4] A scheme often will involve multiple actors, and investors are entitled to allege "*that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme*." *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997).

Because §10(b) makes it "unlawful for any person" to "directly or indirectly" "use or employ" a "deceptive device or contrivance" causing economic loss "in connection with the purchase or sale of any security," 15 U.S.C. §78j, its plain language proscribes deceptive *conduct* that purposefully causes a misrepresentation by a public company in connection with the purchase of a security. In *United States v. O'Hagan*, 521 U.S. 642 (1997), referencing the sentence from *Central Bank* in which the Court gave a shorthand definition of deceptive conduct that some had construed as limiting such conduct to misstatements or omissions (511 U.S. at 177), this Court clarified that no such limitation was intended:

> The Eighth Circuit isolated the statement just quoted and drew from it the conclusion that §10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely. It is evident from the question presented in *Central Bank*, however, that this Court, in the quoted passage, sought only to clarify that secondary actors, although not subject to aiding and abetting liability, *remain subject to primary liability* under §10(b) and Rule 10b-5 *for certain conduct*.

O'Hagan, 521 U.S. at 664.

[4] Citations and footnotes are omitted and emphasis is added unless otherwise noted.

For more than 60 years, this Court has recognized "beyond peradventure" the existence of an implied private right of action for damages for violation of §10(b). *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983). In enacting the Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (1995) ("PSLRA"), with all of its procedural and substantive standards for private suits, Congress effectively made the private right of action explicit: "The provisions of this subsection shall apply in each private action arising under this title that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure." 15 U.S.C. §78u-4(a)(1).

Respondents assert that Congress also codified their very different reading of *Central Bank* in enacting the PSLRA — simply overlooking the fact that the PSLRA specifically envisioned liability *for fraudulent conduct*. Just a year after *Central Bank*, 511 U.S. at 191, and its statement that in most complex cases "there are likely to be multiple violators," Congress substantially revised the law governing the §10(b) private right of action, including the rules for joint-and-several liability, 15 U.S.C. §78u-4(f), an issue presented in any multi-actor case. Congress provided that *proportionate liability* would be the general rule, but that joint-and-several liability would still exist, if and only if, (i) those who make a false statement do so "with actual knowledge" of its falsity *or (ii) those who engage in* "*conduct [do so] with actual knowledge of the facts and circumstances that make the conduct . . . a violation of the securities laws*." 15 U.S.C. §78u-4(f)(10)(A)(ii).

Congress, in passing the PSLRA, thus demonstrated its intention to continue to prohibit deceptive conduct as well as deceptive statements and omissions. Addressing proportionate liability, moreover, Congress both revised the Securities Exchange Act of 1934 and defined "a covered person" under the Act in two parts. 15 U.S.C. §78u-4(f)(10)(A)(i) and (ii).

In part (i), Congress defined requirements for "an action that is based on an untrue statement of material fact or omission of a material fact." *Id.* In part (ii), Congress defined requirements for "an action that is based on any *conduct* that is not described in clause (i)." *Id.* Congress clarified that a "covered person" is one who "engages in that *conduct* with actual knowledge of the facts and circumstances that make the *conduct* of that covered person a violation of the securities laws." *Id.* The statute must be read "so as to avoid rendering superfluous any parts thereof." *Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 112 (1991). Section (ii) demonstrates Congress's intent to continue to make unlawful deceptive *conduct* — as well as statements and omissions, which are covered by section (i).

Prior to *Central Bank*, this Court had expressly stated that a defendant violates Rule 10b-5 when it engages in "a 'course of business' or a 'device, scheme, or artifice' that operate[s] as a fraud." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972). Nothing in *Central Bank* changes that. Indeed, continuing to follow the statute's plain language, this Court recently held that to prove a violation, plaintiff must "prove that the defendant's misrepresentation (*or other fraudulent conduct*) proximately caused the plaintiff's economic loss." *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 346 (2005).

In any event, all of this just demonstrates that there is a substantial disagreement on this legal issue between investors and the Wall Street banks. Investors believe that the language of §10(b) and Rule 10b-5 protects them from being victimized from fraudulent conduct — including schemes to defraud engaged in by Wall Street banks. The Wall Street banks think that even this kind of conduct should be immune from liability so they will not be subjected to the risks and uncertainties of liability which everyone else in our society endures as part of an ordered legal system that balances rights, obligations and remedies in commercial and financial matters. There is a Circuit split on the issue and a further division among the district courts. This issue — described by some as the most important securities-law issue the Court will decide in this generation — is teed-up in the *Stoneridge* case and Petitioner respectfully believes that it would be of assistance to the Court in deciding this issue if this *Enron* case were decided at the same time; or at least that the unique aspects of this Enron fraud be firmly in the Court's mind as it decides the *Stoneridge* case and thus the fate of the Enron investors.

IV. CONCLUSION

This case presents the opportunity for this Court to decide the Question Presented in the context of the most notorious fraud of our time where the leading Bank Defendants are the very market actors whose conduct Congress intended §10(b) to regulate. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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