No. 06-43

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

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

BRIEF FOR AMICI CURIAE STATES OF ARKANSAS, NEW JERSEY, RHODE ISLAND, AND THE NEW YORK STATE COMMON RETIREMENT FUND, PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM, PENNSYLVANIA STATE EMPLOYEES' RETIREMENT SYSTEM, AND THE MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM OF MICHIGAN IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS CURIAE[1]

The Amici States, as guardians of the citizenry, have a paramount interest in the enforcement and proper interpretation of the securities laws. The States give recognition to and confer both rights and responsibilities on corporations. Thus, the reach of the federal securities laws, and the scope of conduct covered by those laws, are of great concern to the States and their citizens.

The Amici public pension funds, as fiduciaries to the public employees who rely on them to prudently manage their retirement funds, are among the largest institutional investors, public or private, in the United States, and have a special responsibility to help insure the transparency of the capital markets and the accountability of their participants.

Together, the Amici States and the Amici public pension funds manage an aggregate $360 billion invested in the public markets. Combined, they manage the retirement plans for over over 2.7 million active and retired public servants. Increasingly, the Amici States and Amici public pension funds act as lead plaintiffs in securities class actions, and in the aggregate currently serve as lead plaintiffs in 14 pending securities class actions. As lead plaintiffs, Amici play a pivotal role in enforcing and deterring violations of the securities laws and in recovering losses for investors and pensioners victimized by fraud. As large public institutional investors, Amici are especially effective lead plaintiffs, just as Congress contemplated when it devised the lead plaintiff provisions of the Private Securities Litigation

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[1] Pursuant to this Court's Rule 37.6, Amici state that no counsel for any party authored this brief in whole or in part, and no person or entity other than amicus curiae, its members, or its counsel, has made a monetary contribution to the preparation or submission of brief. Pursuant to Rule 37.3, the parties' letters of consent to the filing of this brief have been lodged with the Clerk.

Reform Act of 1995, and as courts have consistently recognized since.

The Court's decision in this case will greatly impact the Amici States' ability to fulfill their roles as protectors of the public interest, and the Amici public pension funds' ability to fulfill their roles as fiduciaries of publicly managed funds.

SUMMARY OF ARGUMENT

The Securities Exchange Act of 1934 forbids "any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe. . . ." 15 U.S.C. §78j(b).[2] By its terms, the statute places no limits on the persons who can be liable or on the types of "manipulative or deceptive devices or contrivances" that are prohibited. Thus,

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[2] The Securities and Exchange Commission ("SEC") has promulgated Rule 10b-5, 17 C.F.R. § 240.10b-5, which prohibits

> any person, directly or indirectly . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The decision below did not address the scope of the rule, which has been held to be "coextensive with the coverage of § 10(b)," *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002), but instead analyzed only whether the alleged conduct could be considered manipulative or deceptive under the statute, *see In re Charter Communications, Inc., Securities Litigation*, 443 F.3d 987, 992-93 (8th Cir. 2006).

under any reading, this language must forbid persons or entities from structuring transactions in a manner that has no legitimate business purpose other than to permit the creation of false financial statements for public distribution.

Disregarding the statute's text, the Eighth Circuit in *In re Charter Communications, Inc., Securities Litigation*, 443 F.3d 987 (8th Cir. 2006), concluded that nothing in Section 10(b) forbids third-party entities from intentionally engaging in sham transactions for the purpose of having those transactions falsely reported to the investing public by their business partners. The court reached this surprising conclusion in three steps, each of which was error.

First, the court erred by adopting a constricted reading of the statute to forbid only the making of false statements (or misleading omissions) and manipulative trading practices. However, as this Court has previously made clear, the statute forbids all forms of deceptive conduct that are intended to falsely affect the price of a security. When the fraud is ultimately consummated through the issuance of a false financial statement, as occurred in this case, the statute prohibits any acts that caused the statement to issue, so long as those actions are "deceptive." Because sham contracts, wash transactions, and the like are "deceptive" under any definition of that term, and because – as alleged here – such transactions were necessary to the fraud's consummation, liability should lie under Section 10(b).

The Eighth Circuit's next error was to conclude that liability will lie for an omission only if the actor operates under a preexisting fiduciary duty of disclosure. Because, in the Eighth Circuit's view, outside entities that do business with fraudsters operate under no such duty, the court concluded that the vendor-defendants could not be held liable for failing to disclose the false financial reporting. The Eighth Circuit thus failed to

recognize that both this Court and others have repeatedly emphasized that one who intentionally participates in another's breach of fiduciary duty inherits the same duties of disclosure as the original fiduciary – and is equally liable for a failure to disclose material information. Because the vendors in this case intentionally participated in just such a breach by purposefully providing Charter's corporate officers with information intended to be falsely reported to the investing public, the vendors were subject to a duty of disclosure. They can thus be held liable for remaining silent in the face of Charter's fraud.

Finally, the Eighth Circuit reasoned that, despite the vendor-defendants' purposeful injection of false information into the market, the vendors had not made, nor caused to be made, any false statements. However, every circuit to consider the issue has agreed that Section 10(b) not only forbids persons from personally making false statements, but also forbids persons from channeling false information to the market through intermediaries and third parties. In this case, the vendors intentionally provided false information to Charter for the purpose of having Charter distribute that information to the public in its financial statements. The vendors may thus be held liable for the damages caused by that false information.

ARGUMENT

I. MODERN COMPLEX FRAUDS RELY ON THE PARTICIPATION OF MULTIPLE ACTORS

It is no coincidence that certiorari petitions in *Charter Communications*, *Regents of University of California v. Credit Suisse First Boston (USA), Inc.* ("*Credit Suisse*"), 482 F.3d 372 (5th Cir. 2007), and *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), came before this Court at roughly the same time. These actions, with facts that, as the Fifth Circuit observed, are "extraordinarily similar," *Credit Suisse*, 482 F.3d

at 388, are emblematic of the sophisticated forms of accounting fraud that have been at the center of a wave of scandals dating from the late 1990s. These scandals, which have resulted in the spectacular implosions of some of Wall Street's biggest names, have had one thing in common: the degree to which the fraud could never have been accomplished but for the active, intentional, and purposeful participation of third parties – auditors, bankers, insurers, and business partners.

The extent to which these frauds have depended on the participation of outside entities has by now been well documented. Not only did these outside entities engage in transactions designed for the sole purpose of hiding their clients' debt and (falsely) increasing clients' reported revenues and cash flow, but, in many cases, auditors, insurers, and investment bankers specifically designed new fraudulent structures and openly marketed them to their clients. For instance, Robert Roach, Chief Investigator for the Senate Permanent Subcommittee on Investigations, testified before Congress that a number of financial institutions intentionally sold fraudulent, Enron-style accounting structures known as "prepays" to their other clients:

> [JP Morgan] Chase developed a "pitch book" to sell other companies on Enron-style prepays. The presentation describes the transactions as "Balance sheet 'friendly'." It also sets out in general terms Chase's use of its special purpose entity, Mahonia, in structuring the trades and clearly explains that the trades are orchestrated to work together. This explanation of the deliberate packaging of the trades flatly contradicts claims that the trades are independent and unrelated. Chase apparently entered into Enron-style prepays with seven companies apart from Enron.

> Citigroup also developed a presentation to sell companies on Enron-style prepays, promoting, in particular, the Yosemite structure it had developed … Citigroup shopped this Enron-style prepay to 14 companies, successfully selling it to at least three."

1 *The Role of Financial Institutions in Enron's Collapse: Hearings before the Permanent Subcomm. Of Investigations of the Senate Governmental Affairs Committee*, 107th Cong. (2002) (statement of Robert L. Roach, Chief Investigator, Permanent Subcomm. on Investigations). The accounting firm of Arthur Andersen developed a "white paper" that it distributed to telecommunications companies, explaining how to avoid certain accounting standards in order to create fictitious revenue. *See* Dennis K. Berman, Julia Angwin and Chip Cummins, *Tricks of the Trade: As Market Bubble Neared End, Bogus Swaps Provided a Lift*, Wall St. J., Dec. 23, 2002, at A1. And in 2003, the insurance company A.I.G. paid $10 million to settle the SEC's charge that it had "played an indispensable part" in the fraud at a company called Brightpoint by selling it an insurance product "that A.I.G. had developed and marketed for the specific purpose of helping issuers to report false financial information to the public." Gretchen Morgenson, *S.E.C. Wants a Monitor to Examine A.I.G.'s Books*, N.Y. Times, Nov. 3, 2004, at C1.

Under any ordinary reading of the Securities Exchange Act of 1934 ("Exchange Act"), this would seem to be precisely the kind of conduct forbidden by the statute. Section 10(b), 15 U.S.C. § 78j(b), makes it unlawful for any person "directly or indirectly . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." The Exchange Act was passed in the aftermath of the 1929 market crash, and, in addition to outlawing a number of specific manipulative

practices, included Section 10(b) as a "catch-all" provision to prohibit "any other cunning devices" that were not identified elsewhere in the statute or that might be developed after the statute's passage. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-03 (1976) (quoting legislative history). The statute was explicitly intended to address the fact that some fraudulent conduct takes place "behind the scenes": not only does it ban use of manipulative devices both "directly" and "indirectly," but, as this Court acknowledged, the statute applies equally to issuers and to lawyers, banks, and accountants, for "[i]n any complex securities fraud, [] there are likely to be multiple violators." *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 191 (1994).

But despite what would appear to be the plain language of the statute and the obvious intention of Congress to ban precisely this sort of behavior – which, as alleged in this action, involves planned, premeditated, and coordinated market manipulation – the Eighth Circuit in *Charter*, followed by the Fifth Circuit in *Credit Suisse*, determined that when an outside entity intentionally engages in transactions for the purpose, and with the effect, of having those transactions falsely reported to the market through the financial statements of clients and customers, such conduct is neither "manipulative" nor "deceptive." *See Charter*, 443 F.3d at 992-93; *Credit Suisse*, 482 F.3d at 387-90. Rather, both courts concluded that such conduct can be no more than "aiding and abetting" – conduct that, per this Court's decision in *Central Bank*, is not prohibited by the text of Section 10(b). *Central Bank*, 511 U.S. at 177-78.

If permitted to stand, these decisions provide a road map for committing fraud, and represent a true threat to the integrity of the securities markets. As Professor Coffee has observed, third party "gatekeepers" play a critical role in keeping corporations honest. *See* John C. Coffee, *Understanding Enron:*

"It's About the Gatekeepers, Stupid," 57 Bus. Law. 1403 (2002). These gatekeepers may be more responsive to the threat of liability than their clients, for they depend on reputational capital to maintain their businesses, *see, e.g.*, Paul Beckett and Jathon Sapsford, *Citigroup's Vast Reach Brings It Trouble From Many Quarters*, Wall St. J., July 26, 2002, at A1, and they do not reap the immediate "benefits" of fraud through increases in their own stock prices. Insulating gatekeepers from liability for the costs of their misconduct will encourage future frauds. Nor can it be said that governmental enforcement actions will provide all required deterrence; as Congress has explained, "[P]rivate lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31, at 31 (1995); *see also* Brief for the United States as Amicus Curiae Supporting Petitioners at 1, *Tellabs Inc. v. Makor Issues & Rights*, No. 06-484 (Feb. 9, 2007) ("[M]eritorious private actions are an essential supplement to criminal prosecutions and civil enforcements.").

II. SECTION 10(B) FORBIDS PARTICIPATION IN TRANSACTIONS INTENTIONALLY DESIGNED TO ENABLE FRAUD

A. *Central Bank* and its History

Prior to this Court's decision in *Central Bank*, it was generally accepted among the circuits that liability would lie for aiding and abetting violations of Section 10(b). Because the penalties for aiding and abetting were often similar to those for primary violations, courts rarely distinguished between the two types of liability. *See In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 494 (S.D.N.Y. 2005); *see also Shapiro v. Cantor*, 123 F.3d 717, 720 n.2 (2d Cir. 1997). Frequently, courts characterized

any conduct by a secondary *actor*, such as an outside auditor, as "aiding and abetting," even when the actor directly issued false statements under its own name – conduct that today would be easily recognized as sufficient to incur primary liability. *See Parmalat*, 376 F. Supp. 2d at 495 (discussing cases).

Courts also differed as to how "aiding and abetting" was defined. For instance, in *Harmsen v. Smith*, 693 F.2d 932 (9th Cir. 1982), the Ninth Circuit listed the elements of aiding and abetting as "(1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong." *Id*. at 943. In *DBLKM, Inc. v. Resolution Trust Corp.*, 969 F.2d 905 (10th Cir. 1992), the Tenth Circuit held that recklessness would satisfy the scienter element of an aiding and abetting claim. *See id.* at 909. And in *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986), the Seventh Circuit required that the alleged aider and abetter have "committed one of the 'manipulative or deceptive' acts or otherwise met the standards of direct liability." *Id.* at 495. That court distinguished its aiding and abetting test from primary liability by requiring that the primary violator "offer or sell the securities." *Id.*[3] In many circuits, the scienter requirement for aiding and abetting liability varied with the degree of assistance the alleged aider had provided the primary violator; the more substantial the assistance, the lower the scienter requirement. *See Metge v. Baehler*, 762 F.2d 621, 624-25 (8th Cir. 1985). Thus, at the time *Central Bank* was decided, the boundary between "primary" and "secondary" liability was, at best, fluid.

In *Central Bank*, this Court for the first time held that Section 10(b) does not impose liability on those "who do not

[3] This Court has since made clear that no such requirement exists for primary liability to attach. *See Central Bank*, 511 U.S. at 191.

engage in the manipulative or deceptive practice, but who aid and abet the violation." 511 U.S. at 166-67. Reasoning that "the statutory text controls the definition of conduct covered by § 10(b)," *id.* at 175, this Court held that aiding and abetting was not covered by the statute because the statutory text limited its prohibitions to "manipulative or deceptive acts in connection with the purchase or sale of securities.," *id.* at 173.

Critically, however, for the purpose of its analysis, the Court employed the following definition of aiding and abetting: "(1) a primary violation of § 10(b); (2) recklessness by the aider and abettor as to the existence of the primary violation; and (3) substantial assistance given to the primary violator by the aider and abettor." *Id.* at 168; *see also id.* at 190 (emphasizing that "recklessness, not intentional wrongdoing, is the theory underlying the aiding and abetting allegations in the case before us"). The Court did not address the various permutations of aiding and abetting liability that had been applied in the lower courts and, because the plaintiff in *Central Bank* had not charged the defendant with primary liability, the Court was not called upon to distinguish reckless substantial assistance to a primary violator from prohibited conduct "involving manipulation or deception." The *Central Bank* Court thus did not undertake an analysis of what sorts of "acts" might qualify as "manipulative or deceptive" under the statute. As a practical matter, the Court held only that liability under Section 10(b) requires manipulative or deceptive conduct, and that the formulation of reckless substantial assistance was overly broad, "extend[ing] beyond persons who engage, even indirectly, in a proscribed activity . . . but who give a degree of aid to those who do." 511 U.S. at 176.

Notwithstanding *Central Bank*'s clear directive that "the statutory text controls the definition of conduct covered by § 10(b)," 511 U.S. at 175, the Eighth Circuit nonetheless

determined that conduct unquestionably deceptive under any ordinary meaning of the word – the creation of sham contracts and wash transactions with no economic substance – is not forbidden by the statute. *Charter*, 443 F.3d at 992-93. In so doing, the court eschewed any analysis of the statutory text itself; instead, it interpreted this Court's prior cases to have given Section 10(b) a narrow application only to defendants "who [] make or affirmatively cause to be made a fraudulent misstatement or omission, or who [] directly engage in manipulative securities trading practices." *Id.* at 992. Indeed, in *Credit Suisse*, the Fifth Circuit elaborated on the *Charter* court's reasoning by arguing that the word "deceptive" was not to be interpreted in accord with its dictionary definition, but in accord with (what it perceived to be) this Court's "limit" on the "scope" of the term. 482 F.3d at 389. The Eighth and Fifth Circuits' interpretations of *Central Bank* and this Court's other cases are unduly constrained and ignore the plain statutory text.

B. The Eighth Circuit's Overly Narrow Interpretation of Section 10(b) Should be Rejected

The Eighth Circuit's decision rested on three basic propositions. First, as described above, it construed Section 10(b) to forbid only two forms of conduct: false statements (or misleading omissions) and manipulative stock trades. *Charter*, 443 F.3d at 992. Second, the court determined that because the vendor-defendants in this case had not directly made any false statements, and had not engaged in manipulative trading, they could only be held liable for misleading omissions. *Id.* Third, the court concluded that because the vendors had no fiduciary relationship with Charter's shareholders and had not personally issued false statements, they were under no duty to disclose the fraud. *Id*. Each of these conclusions was in error.

i. Section 10(b) Forbids All Forms of Manipulative and Deceptive Conduct

This Court has interpreted the language of Section 10(b) to prohibit "any course of conduct that has the effect of defrauding investors," *Ernst & Ernst*, 425 U.S. at 212, and has made clear that a deceptive course of conduct, within the meaning of Section 10(b), includes participation in a "scheme" to defraud. In *Ernst & Ernst*, for example, this Court defined "device" as "an invention; project; scheme; often, a scheme to deceive." 425 U.S. at 199 n.20. Similarly, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), this Court approvingly quoted the Second Circuit that "§ 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Id.* at 10 n.7 (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)).

Despite the statutory text and this Court's clear admonition that *all* forms of manipulation and deception are forbidden by the statute – including participation in "schemes" – the Eighth Circuit nonetheless reached the conclusion that Section 10(b) forbids only two things: false statements (and misleading omissions), and "manipulative securities trading practices." 443 F.3d at 992. Further, though the statute by its terms applies to anyone who employs a manipulative or deceptive device "directly or indirectly," the Eighth Circuit eschewed this language and instead held that only defendants who "make or affirmatively cause to be made" false statements, or who "directly engage" in manipulative trading, are covered by Section 10(b). *Id.* Such narrow statutory construction is not only flatly at odds with this Court's prior holdings, but confuses the *source* of the injury experienced by the plaintiffs with the *conduct* that led to the injury.

The plaintiffs in this action claim that they were defrauded by Charter's false reports of revenues and cash flows. Complaint ¶12 (JA20a). Thus, the plaintiffs have alleged that they were injured by a false statement, just as the Eighth Circuit required. The only remaining question, then, is whether liability exists for the deceptive conduct that underlies and causes the false statement to issue. And by the plain terms of the statute, it does.

First, there can hardly be any dispute that plaintiffs have alleged that the contracts, wash transactions, and the like were "employed" by the vendors. The vendors are alleged to have signed the contracts, accepted overpayments, and funneled revenues back to Charter. Complaint ¶¶90-114 (JA52a-61a). The vendors actively engaged in the transactions, and thus "employed" them for statutory purposes. *See* Webster's New International Dictionary 839 (2d ed. 1934) (defining "employ" as "to make use of, as an instrument, means, or material; to apply; use; . . . .").

Second, as the Ninth Circuit explained in *Simpson*, it is difficult to imagine how participation in a transaction, "the principal purpose and effect of which is to create the false appearance of fact," 452 F.3d at 1048, can be anything other than "deceptive" under any understanding of that term. The vendors here were alleged to have entered into sham contracts and wash transactions, and they were alleged to have done so for the purpose of having those transactions be communicated to the public through Charter's financial statements. This is the very definition of deceptive. *See, e.g.*, Webster's New International Dictionary 679 (2d ed. 1934) ("tending to deceive; having power to mislead").

The Eighth Circuit faltered at this point by limiting the concept of a "deception" only to the issuance of a false statement (or misleading omission), which, it concluded, the vendors had

not done. *Charter*, 443 F.3d at 992; *see also Credit Suisse*, 482 F.3d at 389 (conceding that the accounting structures at issue qualified as "devices," under this Court's precedent, but disputing that they were "deceptive"). But nothing in the statute requires that a deceptive device be a false statement or omission. Even if the Eighth Circuit is correct that ultimately the fraud can only be *consummated* through a false statement or misleading omission to the market, the statute forbids "devices" and "contrivances," not statements, and therefore must be taken to forbid not only the statements themselves, but also those devices and contrivances that *cause* false statements to issue.[4] This is why this Court has already explained that deceptive "devices" include participation in a scheme. *See Ernst & Ernst*, 425 U.S. at 199 n.20. Such liability would be redundant if only applied to those who had affirmatively made false statements; rather, if the "devices" forbidden by the statute include "schemes," then they must necessarily include some forms of conduct that, perhaps on their own are not direct false statements to the market but, taken in conjunction with other actions,

[4] Of course, had the truth behind Charter's financial statements been disclosed, there would have been no injury, but that fact alone does not transform the case into one based on misleading omissions. Because the securities laws are fundamentally directed at disclosure, *see, e.g.*, *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985); *Santa Fe*, 430 U.S. at 477 ("fundamental purpose of 1934 Act to substitute a philosophy of full disclosure for the philosophy of caveat emptor. . . ." (quotations omitted)), at bottom, every injury premised on affirmative conduct can be reduced to a failure to disclose. *See, e.g.*, *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) ("if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."); *Zandford*, 535 U.S. at 821 (unauthorized trading is deceptive because it was undisclosed); *Santa Fe*, 430 U.S. at 477 (nondisclosure is "essential to the success" of a manipulative trading scheme).

ultimately result in false communications. *See, e.g.*, Webster's New International Dictionary 2234 (2d ed. 1934) (defining scheme as a "plan or program of something to be done; an enterprise; a project . . . A crafty, unethical project"). And, because this Court has already acknowledged that "[i]n any complex securities fraud, [] there are likely to be multiple violators," *Central Bank*, 511 U.S. at 191, there is no reason why the different parts that together constitute a "scheme" – including a scheme to issue false financial statements – must all be undertaken by a single actor.

To support its constricted reading of the statute, the Eighth Circuit quoted *Central Bank*'s statement that "As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Charter*, 443 F.3d at 990 (quoting *Central Bank*, 511 U.S. at 177). However, had the Eighth Circuit quoted the entire passage, it would have been clear that the *Central Bank* Court was concerned with *deception*, not particular forms of conduct:

> As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. *See Santa Fe Industries* [*v. Green*,] 430 U.S. [462,] 473 [(1977)] ("language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); *Ernst & Ernst*, 425 U.S. at 214 ("When a statute speaks so specifically in terms of manipulation and deception . . . , we are quite unwilling to extend the scope of the statute"). The proscription does not

> include giving aid to a person who commits a manipulative or deceptive act.

511 U.S. at 177. This paragraph is not an affirmative holding that the only forms of conduct that violate §10(b) are "statements" (and omissions), and "manipulations." Read in context, it is clear that the Court was addressing the broader point whether liability would lie for any actions that were not, in some sense, deceptive. This is why the Court cited *Santa Fe* and *Ernst & Ernst*, both of which concerned only the question whether unintentional or nondeceptive actions would violate the statute, *see Santa Fe*, 430 U.S. at 473-74; *Ernst & Ernst*, 425 U.S. at 197-99, and why the Court, both in this paragraph and elsewhere in its opinion, repeatedly referred less specifically to deceptive "acts," "conduct," and "practices."

Not surprisingly, then, in *Credit Suisse*, the Fifth Circuit did *not* rely on this passage to support its conclusion that the statute prohibits only statements, omissions, and manipulative trading. Instead, the Fifth Circuit construed the *Central Bank* decision as "informed by a series of decisions . . . narrowly defining the scope of 'fraud' in the context of securities." *Credit Suisse*, 482 F.3d at 387. According to the Fifth Circuit, the *Central Bank* Court, by relying on decisions such as *Santa Fe* and *Ernst & Ernst* (which discussed the concept of "manipulation"), and *Chiarella v. United States*, 445 U.S. 222 (1980) (which noted that claims based on "omissions" must include allegations of a "duty to speak"), had affirmatively limited the scope of potential "manipulative" and "deceptive" acts to the conduct specifically discussed in those opinions. *See Credit Suisse*, 482 F.3d at 387-90. But a cursory glance at the *Central Bank* decision shows that this is simply not so: *Central Bank* relied on these cases *not* in the context of discussing the types of *acts* that would violate the statute, but to make the broader point that Section 10(b) liability turns on

misrepresentation, nondisclosure, or deception – which, the Court believed, was not involved in aiding and abetting liability. So, for example, the Court characterized the *Ernst & Ernst* decision as turning on the need to "protect investors from false and misleading practices," 511 U.S. at 173-74, and described *Santa Fe* as holding that Section 10(b) does not "reach[] breaches of fiduciary duty . . . without any charge of misrepresentation or lack of disclosure," *id.* at 174. Nothing in *Central Bank* even addresses whether conduct other than an affirmative statement, omission, or manipulative trade might be considered "deceptive," and as explained above, the *Central Bank* Court would have had no reason to decide the issue, because the plaintiffs in that action "concede[d] that Central Bank did not commit a manipulative or deceptive act." *Id.* at 191.

The plaintiffs' allegations here also satisfy the element of reliance. As explained above, the plaintiffs' injuries are ultimately traceable to the false statements that Charter issued, and in which the vendors participated. The only question is whether the vendors' deceptive conduct led to the issuance of the false statements. *See Credit Suisse*, 482 F.3d at 397 (Dennis, J., concurring). In this case, not only was the conduct essential to the fraud, but it is also possible to identify exactly the false information that the vendors injected into the market through Charter, and its attendant effect on the value of Charter securities. Therefore, the plaintiffs have properly alleged that they "relied" on the false statements. *See generally Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (element of reliance satisfied by a showing that false information affected market price of the security).

Central Bank is not to the contrary. There, this Court expressed concern that were the aiding and abetting action proposed "in this case" to go forward, plaintiffs would be able to proceed against the alleged aider and abettor, Central Bank,

without a showing of reliance. 511 U.S. at 180. But in that case, Central Bank was alleged merely to have delayed an independent assessment of property values underlying a bond issue, after having already received an appraisal concluding the lands were sufficient collateral. *Id.* at 167-68. The court of appeals had undertaken only a cursory analysis of the relationship of the bank's actions to the primary actor's fraudulent bond issue, *First Interstate Bank, N.A. v. Pring*, 969 F.2d 891, 904 (10th Cir. 1992), with no discussion of what an independent appraisal might have yielded, when it would have been complete, or what effect it might have had on the issue. In other words, in that case, the relationship between Central Bank's actions and the ultimate injury was far more speculative than the relationship alleged here. *See Basic*, 485 U.S. at 243 (explaining that the element of reliance "provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury").

Finally, holding outside entities liable under the facts of this case does not threaten to revive aiding and abetting liability. As explained above, the *Central Bank* Court rejected aiding and abetting liability because it would have improperly extended the proscription of §10(b) to those who merely aided persons who committed manipulative or deceptive acts. The liability proposed on the facts of this case would extend only to defendants who engaged in transactions for the purpose of creating a "false appearance of fact." *Simpson*, 452 F.2d at 1048. "The focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only defendants who use or employ a manipulative or deceptive device) are held liable under the Act." *Id.* at 1049.

ii. Participation in Fraudulent Conduct Triggers a Duty to Disclose

The Eighth Circuit equally erred in concluding that those who intentionally participate in sham transactions for the purpose of enabling fraud have no duty to disclose that fact. To the contrary, in the same way that a corporation, once it has chosen to speak, must speak fully and truthfully, and correct statements that were false when originally issued, *see, e.g.*, *Caiola v. Citibank, N.A.*, 295 F.3d 312, 331 (2d Cir. 2002); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 561 (6th Cir. 2001) (en banc); *Overton v. Todman & Co., CPAs, P.C.*, 478 F.3d 479, 486 (2d Cir. 2007), *Oran v. Stafford*, 226 F.3d 275, 285-86 (3d Cir. 2000); *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990) (en banc), so too does intentional, active participation in fraud give rise to a duty of disclosure.

In *Chiarella*, for example, this Court explained that a "tippee" who wrongly receives confidential information from a corporate fiduciary inherits the same fiduciary duties to disclose the information or refrain from trading on it. *See* 445 U.S. at 230 n.12. As this Court explained, "the tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." *Id.*; *see also Dirks v. SEC*, 463 U.S. 646, 659 (1983) ("[T]he tippee's duty to disclose or abstain is derivative from that of the insider's duty.").[5]

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[5] In *Dirks*, a pre-*Central Bank* case, the tippee-defendant had been charged by the SEC with aiding and abetting the original breach. This Court did not discuss the nature of the SEC charge, but merely discussed the source of a tippee's own duty to the corporation's shareholders. Notably, in *Chiarella*, which involved primary liability, this Court also discussed the tippee's own duty to shareholders, approvingly citing *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), in which tippees were charged with primary violations

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The tippee's status as a participant, moreover, turns on his knowledge; though he assumes no fiduciary obligations if he is unaware of the wrongfulness of the insider's conduct, the tippee "assumes a fiduciary duty to the shareholders of a corporation [when] . . . the tippee knows or should know that there has been a breach." *Dirks*, 463 U.S. at 647.

The *Chiarella* and *Dirks* decisions are by no means unusual; numerous courts both before and after *Central Bank* have recognized that the existence of a duty of disclosure depends on an examination of several factors, including the defendant's degree of participation in the fraud and its level of scienter. For instance, in *Rudolph v. Arthur Andersen*, 800 F.2d 1040 (11th Cir. 1986), the Eleventh Circuit explained that a court may consider, among other things, "the extent of the defendant's knowledge and the significance of the misstatement . . . . The extent of the defendant's participation in the fraud might also be important." *Id.* at 1043; *see Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1206 (11th Cir. 2001) (same). Similarly, the Ninth Circuit has explained that a duty to disclose arises from the "knowing assistance of or participation in a fraudulent scheme." *Harmsen*, 693 F.2d at 944 (quotation omitted).[6] Indeed, the

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of Section 10(b). Today, the SEC regularly charges tippees with primary violations of Section 10(b). *See, e.g.*, *SEC v. Warde*, 151 F.3d 42, 47 (2d Cir. 1998); *SEC v. Franco*, 253 F. Supp. 2d 720, 727 (S.D.N.Y. 2003).

[6] Though the Ninth Circuit discussed this disclosure duty in the context of aiding and abetting liability, as described above, that court also defined such liability more strictly than did this Court in *Central Bank*. *See Harmsen*, 693 F.2d at 943. Moreover, courts' failure to carefully distinguish aiding and abetting from primary liability prior to *Central Bank* makes the labels unenlightening; though the Ninth Circuit described this disclosure duty as "secondary," the Eleventh Circuit relied in part on Ninth Circuit precedent when it determined that violation of a disclosure duty arising from participation in fraud constitutes *primary* liability under Section 10(b). *See Rudolph*, 800 F.2d at 1043.

Restatement (Second) of Torts, relied upon in *Chiarella*, 445 U.S. at 228 n.9, emphasizes that there may be a duty to disclose "facts basic to the transaction, if [the defendant] knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, *the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts*." *Id.* § 551(2)(a) (emphasis added). The comments note that courts have required disclosure in situations where "the advantage taken of the plaintiff's ignorance is so shocking to the ethical sense of the community, and is so extreme and unfair, as to amount to a form of swindling," *id.* cmt. k.

Under the standards elucidated above, the Eighth Circuit was simply wrong to hold that third parties have no duties to disclose frauds committed by the people with whom they do business. When those third parties not only have actual knowledge of fraud, but also intentionally participate in it – through sham transactions, or artificial structures designed with the purpose and effect of enabling improper accounting treatment, or "any other cunning devices," *Ernst & Ernst*, 425 U.S. at 202 – those third parties inherit the same duties of disclosure as the original corporation, and may be liable for breaching that duty by remaining silent. Certainly, a person would "reasonably expect disclosure" if a third party, such as a vendor or a lender, knew that its transactions were being falsely described to the public. *Cf. Rudolph*, 800 F.2d at 1044 ("Standing idly by while knowing one's good name is being used to perpetrate a fraud is inherently misleading.").

Nor would imposing a disclosure duty under circumstances such as these revive the aiding and abetting standards rejected in *Central Bank*. *Central Bank* concerned only "reckless," not "purposeful," behavior. *Central Bank*, 511 U.S. at 190. This is a relevant distinction, for it is the third party's level of knowledge

about the wrongdoing of the original fiduciary that gives rise to the reasonable expectation of disclosure and the derivative fiduciary duties. *See Dirks*, 463 U.S. at 661 ("[Tippee] responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty . . ." (quotation omitted)); *Rudolph*, 800 F.2d at 1043 ("A defendant who intentionally did not reveal what he knew to be fraud might more reasonably be expected to speak out than a defendant who merely failed to learn of a material but ambiguous omission."). Moreover, *Central Bank* did not examine the liability of one who furthers the fraud by engaging in transactions intentionally structured for the purpose of being falsely reported to the public – but this is precisely the conduct that distinguishes one who gives "a degree of aid" to persons engaging in fraudulent conduct, 511 U.S. at 176, from the type of active participation that triggers the derivative fiduciary duty of disclosure.

iii. Section 10(b) Forbids Entities from Using Others as Conduits to Distribute False Information to the Public

Finally, the Eighth Circuit erred in concluding that the vendors cannot be held responsible under Section 10(b) for Charter's false statements. To the contrary, when an entity deliberately supplies false information to another party with the purpose and intent that it be communicated to the public, that entity has violated Section 10(b). Because the vendors here are alleged to have purposefully supplied Charter with false information in the form of sham contracts and fictional rate increases, they, too, are liable for false public communications that incorporated such information.

It is widely agreed among the circuits that a person cannot escape liability under Section 10(b) by using another person as

a "conduit" to communicate false information to the market. Thus, in *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997), a corporation was accused of having provided false information to analysts, who then used that information to issue unduly positive recommendations to the public. *See id.* at 623-24. Notwithstanding the fact that the false information had been channeled to the market through third parties, the Ninth Circuit explained that "corporate defendants may be directly liable under 10b-5 for providing false or misleading information to third-party securities analysts." *Id.* at 624. As that court explained, a defendant "cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties." *Id.* (quoting *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996)). *Cooper*'s holding that entities may not use other persons as "conduits" to channel false information to the market has won wide acceptance among the courts of appeals. *See Rombach v. Chang*, 355 F.3d 164, 174 (2d Cir. 2004) (quoting *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163-64 (2d Cir. 1980)); *Southland Secs. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 373 (5th Cir. 2004); *In re Navarre Corp. Secs. Litig.*, 299 F.3d 735, 743 (8th Cir. 2002). Indeed, even the *Charter* court apparently recognized the validity of the theory, for it carefully allowed that liability would attach if a defendant "affirmatively cause[d] to be made a fraudulent misstatement or omission." *Charter*, 443 F.3d at 992.[7]

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[7] The 1934 Congress was unquestionably aware of, and concerned about, the use of ostensibly independent parties to funnel false information to the market. As the Senate Committee report explained:

> Other devices commonly resorted to in the past, and banned by the bill are the dissemination of false information and tipster sheets. The record shows that it was not uncommon for market operators to employ a publicity agent to tout a stock in which they were momentarily interested. In one

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If there were any remaining doubt, it would be resolved by looking to common law at the time of the Act's passage.[8] At that time, the *Restatement (First) of Torts* explained:

> The maker of a fraudulent misrepresentation in a business transaction is subject to liability to another who acts in justifiable reliance upon it if the misrepresentation, although not made directly to the other, is made to a third person for the purpose of having him repeat its terms or communicate its substance to the other in order to influence his conduct in a particular transaction or type of transaction.

Restatement (First) of Torts § 533. For the purposes of this

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> instance a financial writer on a great New York newspaper was discovered to have been a regular participant in the profits of a free-lance trader, without obligation except to publicize the stocks of the trader. Another witness admitted that his business was 'financial publicity', and that his articles were published for the purpose of interesting the public in the stock in which he and those who employed him were interested, thereby causing the market value of the stock to increase; and for this work he was paid by calls and options. Still other cases were observed where persons were employed to broadcast over the radio, ostensibly as economists tendering gratuitous advice, but in reality as publicity agents of stock-exchange firms.

S. Rep. No. 792, 73d Cong., 2d Sess., at 8 (1934).

[8] The Exchange Act was passed in part to broaden the common law protections against fraud, *see Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983); therefore, common law understandings of fraud are helpful in understanding the type of conduct Congress sought to prohibit.

principle, it is irrelevant that the vendors may not have had their own independent pecuniary interest in defrauding Charter's shareholders. As the *Restatement* explained, "[t]he misrepresentation must be made for the purpose of having it repeated in terms or communicated in substance to the third person. If it is made for such purpose, the rule is applicable although the maker of the representation has no interest, either direct or indirect, in the transaction in which its repetition influences the third person." *Id.* cmt. b.[9]

To be sure, the Second Circuit, relying on *Central Bank*, held in *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998), that to trigger Section 10(b) liability, false information distributed through another entity must be publicly attributed to its original source. *See id.* at 175. The circuit reasoned that there can be no "reliance" if the public is unaware of the origin of the statement. *See id.* But the *Wright* court – apparently unwilling to overrule the conduit theory (which carries no such caveat) – drew a distinction between "primary" actors who channel false statements to the market through intermediaries, and "secondary" actors who do the same thing, holding only that "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination." *Id.* at 175.[10]

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[9] The *Restatement (Second) of Torts* espouses the same principle. *See Restatement (Second)* § 533.

[10] In *Wright*, the "secondary actor" was alleged to have done no more than simply review and approve the false statements. *Wright*, 152 F.3d at 175. The Second Circuit observed that even if secondary actors could be responsible for unattributed statements, the defendant's participation in that instance was likely too slight to incur liability. *See id.* at 175-76. In this case, of course, the vendors are alleged to have done far more than simply "review" Charter's statements; they are alleged to have contributed substantive, and false, content.

As should be immediately obvious, there is simply no basis in the statute or even logic to draw such a distinction. If an investor must know the identity of the original source of the information in order to "rely" on it, there is no reason why that rule should be any different when the anonymous participant is a "secondary" rather than a "primary" actor. More importantly, people rely on *information*, not speakers – and though the perceived source of the information may contribute to its materiality (a statement by a corporate issuer might carry more weight than, say, a statement by a lone internet commenter) – the relevant question is whether *information* supplied by the (anonymous) actor was relied upon by the public. Indeed, this Court itself has previously held that secondary actors *can* be held liable under Section 10(b) when they assist in the preparation of statements that are not attributed to them – it is, in fact, the potential for such liability that distinguishes liability under Section 10(b) from liability under Section 11 of the Securities Act of 1933, and was one of the reasons that this Court held that Section 11 was not the sole remedy for false statements in registration statements:

> [C]ertain individuals who play a part in preparing the registration statement generally cannot be reached by a Section 11 action. These include corporate officers other than those specified in 15 U.S.C. § 77k(a), lawyers not acting as "experts," and accountants with respect to parts of a registration statement which they are not named as having prepared or certified. 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.

Herman & MacLean v. Huddleston, 459 U.S. 375, 386 n.22 (1983).

Therefore, it is hardly surprising that most courts have not embraced *Wright*'s "attribution" theory or its distinction between "primary" and "secondary" actors – *Wright* is mainly cited for a variety of other propositions. *See, e.g.*, *Weiss v. S.E.C.*, 468 F.3d 849, 855 (D.C. Cir. 2006) (citing *Wright* for the proposition that a defendant "could incur liability for his misrepresentations even when he did not communicate them directly to investors"); *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004) (citing *Wright* to support its finding of no liability where auditor-defendant "did not assist in the preparation or presentation of this financial information, nor did it ever express an opinion about it.").

Here, it is alleged that the vendors intentionally provided false information to Charter – through sham price increases, sham advertising revenues, false contracts, and so forth – for the express purpose of having Charter then communicate that information to the public via its financial statements. Though ordinarily entering into a business transaction might not be considered to be a "statement" or the furnishment of information in the ordinary sense, as alleged here, the transactions were not designed for ordinary business purposes but instead existed to be communicated publicly. In other words, the transactions in question were "employed" by the vendors as a device to mislead the market. Thus, the Eighth Circuit was simply incorrect to conclude that "[n]one of the alleged financial misrepresentations by Charter was made by or even with the approval of the

Vendors," *Charter*, 443 F.3d at 992; to the contrary, the vendors supplied false information, and most certainly approved of Charter's misrepresentations, by intentionally engaging in sham business transactions for their informational value.

Nor is it relevant that, in this instance, Charter officers knew that the information supplied by the vendors was false when they incorporated it into Charter's public statements. In *Cooper*, many of the analyst-conduits were alleged to have known that the corporation was feeding them false information, and yet the corporation was still deemed liable for false information that was channeled to the market. *See Cooper*, 137 F.3d at 625. Moreover, joint participants in a fraud have long been treated as equally liable, without any requirement that one be acting as an innocent agent of another. *See Dirks*, 463 U.S. at 659 (the transactions of those who knowingly participate with the fiduciary in such a breach are "as forbidden" as transactions "on behalf of the trustee himself" (quoting *Mosser v. Darrow*, 341 U.S. 267, 272 (1951)); *Chiarella*, 445 U.S. at 230 n.12 ("The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."); *Huddleston*, 459 U.S. at 659 n.22 (Section 10(b) liability will lie for all parties who "engaged in fraudulent conduct while participating in the registration statement"); *Mertens v. Hewitt Associates*, 508 U.S. 248, 254 (1993) (at common law, knowing participants in a trustee's breach of duty were liable to the beneficiary).

Indeed, it seems that the only potential relevance of Charter's own belief, or not, in the false information supplied by the vendors would be if Charter's informed decision to include the false information in its financial statements constituted a supervening cause that broke the chain of causation between the vendors' conduct and the plaintiffs' injuries. However, it is by now well established that the intervening

conduct of another entity – even wrongful, or criminal conduct – is not a supervening cause unless it is entirely unforeseeable and unrelated to the original misconduct. *See, e.g.*, *Atchison, Topeka & Santa Fe Ry. Co. v. Calhoun*, 213 U.S. 1, 7 (1909); *Whitehead v. Food Max of Mississippi, Inc.*, 163 F.3d 265, 271 (5th Cir. 1998); *Marshall v. Perez Arzuaga*, 828 F.2d 845, 848 (1st Cir. 1987). Here, the vendors' participation – far from being divorced from plaintiffs' injuries – was actually necessary to Charter's fraud; had they not agreed to engage in wash transactions and other devices, Charter would not have been able to falsify its financial statements in the manner alleged.

CONCLUSION

As succinctly stated by Circuit Judge Dennis concurring in *Credit Suisse*, the interpretations of the Fifth and Eighth Circuits "immunize[] a broad array of undeniably fraudulent conduct from civil liability under Section 10(b), effectively giving secondary actors license to scheme with impunity, as long as they keep quiet." 482 F.3d at 394 (Dennis, J., concurring). This is not what the plain language of the statute requires, and cannot be what was intended by the 1934 Congress. For that reason, the Eighth Circuit's decision should be reversed.

Respectfully submitted,

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