Chapter 8

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§ 8:1 Introduction to Fraud Concepts in Public Finance
§ 8:1.1 Antifraud Rules: The Centerpiece of Public Finance Securities Regulation

Neither the 1933 Act nor the 1934 Act authorizes the SEC to adopt rules specifying disclosure requirements for issuers of municipal securities in a new issue distribution. Section 15(c)(2)(D) of the 1934 Act authorizes the SEC to adopt rules and regulations to prevent fraudulent acts and practices by broker-dealers in the purchase or sale of any securities, including municipal securities, but the section is limited to broker-dealer rules. The key word is “prevent,” and preventive rules, such as Rule 15c2-12, allow the SEC to prescribe rules establishing standards of conduct. Preventive rules are not authorized by section 17(a) of the 1933 Act or section 10(b) of the 1934 Act. Section 10(b) makes it unlawful to engage in fraudulent conduct in contravention of rules and regulations of the SEC defining fraudulent conduct. Thus, Rule 10b-5 defines fraudulent conduct in connection with the purchase or sale of any security, but does not dictate disclosure or other practices to prevent fraud.

Section 14(e), the antifraud rule applicable to tender offers, is drafted comparably to section 15(c)(2)(D). Section 14(e) requires the SEC to adopt rules and regulations not only to “define” fraudulent conduct, but also to “prescribe means reasonably designed to prevent” fraudulent conduct in connection with any tender offer. Accordingly, the SEC has adopted Regulation E, which sets forth detailed rules for the conduct of tender offers for any securities except government and municipal securities. But section 14(e) is authority for the SEC to adopt rules governing the procedures of municipal tender offers if the SEC chooses to make such rules. The SEC can adopt rules for the conduct of underwriters of municipal securities (for example, Rule 15c2-12) and the conduct of states and political subdivisions in making tender offers for the purchase of their securities, but it cannot adopt rules directly requiring issuers to make specific disclosures in new issues of municipal securities.

It follows that, unless Congress enacts legislation authorizing the SEC to prescribe rules to prevent any person from engaging in fraudulent conduct in the offer, purchase, or sale of municipal securities, the SEC’s principal means to regulate issuers of municipal
securities is to bring an enforcement action to punish fraudulent conduct that has already occurred. Issuers of municipal securities are regulated, not by procedural rules, but by enforcement proceedings and litigation under the antifraud rules. The burden of policing conduct in the courtroom falls more heavily on the SEC than on private litigants because there are procedural and substantive requirements for a private civil action that do not restrict the SEC. For example, a civil action plaintiff must show economic loss, or damages, and loss causation, a burden that is more difficult in the debt market than in the equity market because the subject municipal bonds may not be in default, despite the fraudulent conduct. Likewise, civil plaintiffs are barred from bringing an action against aiders and abettors, whereas section 20(e) of the 1934 Act authorizes the SEC to bring an action against “any person that knowingly provides substantial assistance to another person” in violation of the 1934 Act or the SEC rules and regulations thereunder.

The effect of the SEC’s unique position in public finance regulation is that enforcement must serve more objectives than simply dealing with the wrongdoer in a particular case. A necessarily unstated purpose of an enforcement action in public finance is a signal to the industry of a practice that the SEC considers not only wrongful, but a subject matter that the SEC might consider appropriate for a disclosure rule if Congress were to give it authority to adopt disclosure rules. For example, the SEC has brought enforcement actions related to misleading information in official statements about the use of proceeds in a note or bond offering. Particularly significant are statements that knowingly, or with reckless disregard of the consequences, fail to disclose that the expected use of proceeds may not be in compliance with arbitrage requirements, with the possibility the Internal Revenue Service could declare securities to be taxable when they are sold on a tax-exempt basis.1

Misrepresentations about the use of bond proceeds were at the heart of enforcement actions brought by the SEC against participants in eleven bond offerings for Heritage Healthcare Systems. The purported purpose of each of the eleven issues was to finance the development of a specified healthcare facility. The facilities consisted of one hospital and various senior living facilities in Texas, Florida, Illinois, and California. From the outset, the cost of each development, including diversion of funds to the promoters, outstripped the amount raised from the respective bond issues. The proceeds from each new bond

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issue were used not to finance solely the facility described in the official statement, but also to cover shortfalls in funds available for prior developments. The Ponzi scheme was set forth in the SEC’s 2004 complaint filed in the district court for the northern district of Illinois:

The Defendants covered the resulting cash shortfalls by operating a type of Ponzi scheme, commingling bond proceeds and diverting bond proceeds from more recent offerings to pay the expenses of earlier projects. Eventually all ten of the Heritage facilities failed.

The diversion of bond proceeds from one project to another went on for three years. The Defendants did not mention their diversion of bond proceeds in any of the offering documents, and instead falsely represented that the bond proceeds from each offering would be used only for that respective Heritage facility. Miller & Schroeder continued to sell the Heritage bonds to investors until early August 1999. The following month, September 1999, the Defendants’ commingling and diversion of bond proceeds was publicly disclosed. Beginning in February 2000, the Heritage facilities are in default on their bonds.²

For the people regularly engaged in drafting disclosure documents that, almost invariably, have a section entitled “use of proceeds,” the message should be that the SEC would consider this section important if Congress were to give the SEC authority to require specific disclosures of issuers. Perhaps, instead of simply drafting one sentence stating “the proceeds will be used to finance the project,” the working group should pause to reflect on the importance of the section, since it has been a focus of enforcement actions; draft a clear statement of the use of proceeds; and take the drafting occasion to ask whether the use of proceeds complies with arbitrage rules and whether the proceeds are to be used for legitimate purposes as represented by the issuer or the promoters, and to insist on sufficient detail to force consideration of any potential problems. This inquiry should lead to other material information related to the use of proceeds. As the working group considers the use of proceeds section, it should determine that, in fact, proceeds are to be expended for the purposes described elsewhere in the official statement as providing the sources of revenues and security for the repayment of bonds. Simply put, enforcement actions on use of proceeds should be received by those drafting official statements as a

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prompting message that the use of proceeds section in the official statement should be given diligent attention.

That said, it is important to recognize that the SEC does not control the issues that are the subject of fraudulent conduct. The staff at the SEC may consider it highly significant that disclosure in official statements pay more attention to A, B, and C, but the wrongdoing with which the Enforcement Division is confronted happens to relate to issues X, Y, and Z. Enforcement actions will necessarily target X, Y, and Z, and no rational systemic message can be delivered to the industry through the enforcement actions that are brought. For this reason, the staff does not give any emphasis to the regulatory implications of enforcement action, because to do so could easily distort the relative importance of different areas of disclosure.

[A] The Bias in Antifraud Rules Against Private Actions and Favoring SEC Enforcement in Public Finance

The securities laws have built-in disadvantages for private litigants seeking damage awards in connection with fraudulent conduct in the offer, sale, or purchase of municipal securities. The original purpose of the 1933 Act was to provide a system of “legislation for Federal supervision of traffic in investment securities in interstate commerce,” and the core feature of federal supervision was the registration system. It followed that the express remedies in sections 11 and 12 of the 1933 Act related to misleading information in the registration statement, and on any offers or sales of securities in violation of the section 5 registration requirement. The antifraud rule in section 17[a] gave the SEC enforcement powers, but nothing in the 1933 Act authorized a private cause of action in the offer or sale of section 3[a][2] exempt municipal securities.

The bill before Congress that became the 1934 Act was described as a bill “to establish a Federal Stock Exchange and Securities Commission to regulate transactions in securities on the various stock exchanges, and for other purposes,” and the enacted legislation was called the “Securities Exchange Act.” Section 4 created the SEC, sections 5 and 6 provided for the registration of exchanges, sections 7 and 8 regulated margins and borrowing by securities professionals trading on exchanges, section 9 prohibited manipulation of prices on exchange-traded securities, and section 10 was entitled “Regulation of

the use of manipulative and deceptive devices.” Subsequent sections provided for the 1934 Act reporting system and regulation of broker-dealers. Needless to say, the drafting of the 1934 Act, like the 1933 Act, did not take into consideration any express remedies for investors in municipal securities. The presumption of the 1934 Act was that remedial action would largely be comprised of self-regulatory rules of the registered exchanges and enforcement actions by the SEC. A private cause of action for fraud in the purchase or sale of municipal securities required SEC promulgation of Rule 10b-5 in 1942, the surprise 1946 district court decision that there is an implied private action under section 10(b) and Rule 10b-5, the 1971 endorsement of an implied cause of action by the Supreme Court, and the 1975 Amendments to the 1934 Act to clarify that a “person” subject to section 10(b) liability included the issuer of municipal securities.

The net effect is that private litigants seeking damages as a result of fraudulent conduct in the purchase or sale of section 3(a)(2) exempt municipal securities are confined to the implied cause of action under section 10(b) and the limitations that courts find by reason of a remedy that is not express but judicially created by implication. The SEC, on the other hand, has the advantage of picking and choosing among statutory provisions that were expressly drafted for SEC enforcement. Some of the statutory implications are as follows:

- The SEC, but not private litigants, can bring an action under section 17(a) for fraudulent conduct in the “offer” of securities, thereby reaching conduct that is harmful to holders of securities who choose not to sell as a result of the fraudulent conduct. Standing to bring an action in private litigation under section 10(b) is limited to purchasers or sellers of securities.

- The SEC, but not private litigants, can bring an action under section 17(a)(2) and (3) for negligent conduct. Under section 10(b), private litigants and the SEC must establish scienter as the requisite state of mind of the wrongdoer.

- The 1995 Private Securities Litigation Reform Act (PSLRA) requires plaintiffs in a private cause of action to state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, that is, the defendant’s intention to deceive, manipulate, or defraud. Plaintiff must state with particularity facts giving rise to a “strong inference” that the defendant

acted with the required state of mind. PSLRA was designed to curb perceived abuses of section 10(b) in private actions—“nuisance filings, targeting deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers.”

- A private litigant in a section 10(b) case must demonstrate that the plaintiff relied on the material misrepresentation or omission or the deceptive conduct of the defendant. The SEC does not need to show reliance and can thus use the “in connection with” net to capture a wide range of conduct that cannot be reached by a private litigant limited by the reliance test.

- The reliance requirement limits plaintiffs to causes of action against primary actors and not secondary actors. Section 20(e), added to the 1934 Act by the PSLRA, expressly grants the SEC authority to bring an enforcement action against aiders and abettors. The federal antifraud rules do not allow an implicit cause of action by private litigants against aiders and abettors.

- In addition to statutory authority to bring an enforcement action against aiders and abettors, section 8A of the 1933 Act and section 21C of the 1934 Act give the SEC specific authority to initiate cease-and-desist proceedings not only against primary violators, but also against “any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation.” This statutory authority has been used by the SEC in enforcement proceedings against a financial advisor and a bond counsel in causing entirely separate issuers to violate the securities laws.

9. In its Response to Defendant’s Motion to Dismiss in SEC v. Larry Langford, CV-08-B-0761-S (N.D. Ala., July 14, 2008), relating to municipal bond and swap transactions in Jefferson County, Alabama, the SEC stated: “The broad interpretation of the ‘in connection with’ language is especially true in actions where the Commission is the plaintiff . . . . In Commission actions, the meaning of this language ‘remains as broad and flexible as is necessary to accomplish the statute’s purpose of protecting investors.’” Id. at 26–27 (citing SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993)).
• In a section 10(b) case, plaintiffs in a private cause of action, but not the SEC in an enforcement action, have the burden of pleading and proving that the actionable misconduct of the defendant was responsible causally for monetary damages to the value of the municipal securities. The requirement of loss causation was codified in the PSLRA, which requires plaintiffs to “prove that the act or omission of the defendant alleged to violate [section 10(b)] caused the loss for which the plaintiff seeks to recover damages.”

• Section 15B(c)(1) of the 1934 Act makes a violation of a rule of the MSRB a violation of law, and the SEC, but not a private litigant, can bring an action against a broker-dealer for violations of MSRB rules. The SEC has used this power extensively to deal with market integrity issues, most notably under Rule G-17 on fair dealing, Rule G-20 on gifts, and Rule G-37 on political contributions.

[B] Supreme Court Decisions Favoring SEC Enforcement

Securities lawyers are fond of referring to the SEC and to plaintiffs’ lawyers as two different types of cops on the street. Both have a role to fulfill. The securities laws, as briefly noted in the above bullet points, give the SEC cops more alternatives in combating fraudulent conduct. In addition, decisions of the courts can affect the abilities of the two types of cops to act. In the period 2005 thru 2008, the Supreme Court decided four major securities law cases: Dura Pharmaceuticals, Inc. v. Broudo,14 Merrill Lynch, Pierce, Fenner & Smith v. Dabit,15 Tellabs, Inc. v. Makor Issues & Rights, Ltd.,16 and Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.17 While there is some dispute among lawyers over the effect of these decisions, they are generally interpreted as making the burden of proof more difficult for plaintiffs’

13. See, e.g., In re the Application of Sisung Securities Corporation and Lawrence J. Sisung, Jr., for review and disciplinary action taken by NASD, 1934 Act Rel. No. 56741 [Nov. 5, 2007].

(Fippinger, Rel. #18, 7/09) 8–9
lawyers. The cases will be discussed in the appropriate sections of this chapter, but each is given a brief summary here to indicate how they affect the policing of fraudulent conduct in public finance—tilting it toward the SEC cops and away from plaintiffs’ lawyers bringing civil actions.

The four Supreme Court cases elucidate the six elements of a cause of action under Rule 10b-5:

1. A material misrepresentation (or omission) or deceptive conduct (Stoneridge)
2. Scienter, that is, a wrongful state of mind (Tellabs)
3. A connection with the purchase or sale of a security (Dabit)
4. Reliance, often referred to as transaction causation, that is, a causal connection between the material misrepresentation or deceptive conduct and the decision to purchase or sell in a transaction (Stoneridge)
5. Economic loss (Dura)
6. Loss causation, that is, a causal connection between the material misrepresentation or deceptive conduct and the economic loss (Dura)

In passing, a causation idea appears in three of the six elements. Reliance, or transaction causation, is often defined as requiring an allegation that “but for” (in tort law terminology) the material misrepresentation or deceptive conduct the plaintiff would not have entered into the securities transaction. Transaction causation addresses the reason why a person invested in the securities. The “in connection with” requirement goes to the question of federal jurisdiction by requiring that the material misrepresentation or deceptive conduct has occurred in a securities transaction; but it is also applied in determining that there is a link between the misconduct and the injury. This latter use of “in connection with” overlaps with the sixth element, loss causation. Loss causation is the equivalent of “proximate cause” in tort law terminology and provides the link between the material misrepresentation or deceptive conduct and the economic loss.

_Dura Pharmaceuticals_ required that the plaintiff plead and prove a causal link between the alleged fraud and the economic loss, that is, loss causation. The case involved a claim of false profitability by Dura management and a claim of false representation that an asthma spray device was close to receiving FDA approval. The district court had dismissed both claims (the first for failure to plead scienter and the second for failure to plead loss causation), but the Ninth Circuit
reversed, holding that, as to loss causation, a fraud-on-the-market theory permits a presumption that the price inflation of stock due to the misrepresentation caused the economic injury. Justice Breyer wrote the Supreme Court opinion, holding that pleading price “inflation” alone is insufficient for a pleading of loss causation. The opinion reasoned that the inflated stock price that occurred after the misleading announcement about the asthma spray device may have resulted in a later price loss, but other factors may have subsequently intervened to cause an eventual drop in the price of the security. The complaint failed to state any reasons the share price fell after “the relevant truth [began] to leak out” that the FDA was not going to approve the device, which indicated the plaintiff believed pleading an artificially inflated price alone was sufficient. Justice Breyer rejected the Ninth Circuit’s statement that “plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation.” The effect of the Supreme Court decision is to require plaintiffs to plead facts to show loss causation. “Recognizing Rule 8 of the Federal Rules of Civil Procedure requires only a short plain statement to give fair notice,” Justice Breyer added, “it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection the plaintiff had in mind.” Under Dura, the plaintiff has the burden of linking the misconduct to the price inflation and a subsequent drop in the price of the security. The decision does not affect an enforcement action by the SEC, because the SEC is not required to plead either an economic injury or loss causation.

In Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, a former Merrill Lynch broker brought an action against Merrill Lynch under Oklahoma law, alleging that the firm harmed its brokers and their customers by issuing overly optimistic research reports about the value of certain stock. The class of plaintiffs was defined by Dabit as only those investors who decided to hold securities during the class period, allegedly not selling in reliance on the misrepresentation in the firm’s research reports. Merrill Lynch moved to dismiss on the grounds that the Securities Litigation Uniform Standards Act of 1998 (SLUSA) preempted Oklahoma law, since there was a covered class and a covered security under SLUSA. Dabit replied that SLUSA was inapplicable, because the class of plaintiffs was holders of securities, not purchasers or sellers, and the plaintiffs would not be able to bring a

18. Justice Breyer commented that even the inflated stock price may have been due to factors in addition to the overly optimistic projection of FDA approval.
section 10(b) action because, under *Blue Chip Stamps*, plaintiffs must be purchasers or sellers to have standing under section 10(b). The Second Circuit agreed, holding that SLUSA preempts only state law class action claims brought by plaintiffs who have a private remedy under federal law. The Supreme Court reversed. The Second Circuit had concluded that the claims asserted by holders did not allege fraud “in connection with the purchase or sale” of securities under SLUSA.

Justice Stevens, writing the majority opinion, noted that Congress had adopted SLUSA in 1998 because an unintended side effect of the 1995 PSLRA was that it prompted some plaintiffs to abandon federal antifraud litigation in favor of bringing class actions under state law, and Congress concluded this shift was frustrating the securities reform efforts of PSLRA. Justice Stevens determined that the purchaser-seller standing requirement was not intended to provide an interpretation of the phrase “in connection with the purchase or sale of any security” under section 10(b) (and thus under the same language in SLUSA). The purchaser-seller standing rule, explained Justice Stevens, was based on policy and did not require a narrow reading of the “in connection with” language to mean jurisdiction was limited to material misrepresentations in connection with the plaintiffs’ purchase or sale of their securities. The requisite showing is deception in connection with the purchase or sale of any securities, not just securities of an identifiable purchaser or seller bringing the action. Accordingly, SLUSA required preemption because Merrill Lynch’s wrongdoing was in connection with the purchase or sale of securities even though the plaintiffs were not among those persons purchasing or selling. The effect of the decision is to limit the discretion of plaintiffs’ attorneys to forego the federal securities laws for more favorable state laws, and, by applying a broad definition of the “in connection with” element, the case clarifies the SEC’s ability to pursue a wide range of wrongdoing that links up with any purchases or sales of securities.

*Tellabs* concerned the pleading requirements for scienter under section 21D(b)(2) of the 1934 Act, which was added by PSLRA and


20. The relevant section of SLUSA is:

CLASS ACTION LIMITATIONS.—No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

[A] a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or

[B] that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.
which requires that plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” PSLRA does not define a “strong inference” or indicate how to consider competing inferences. Plaintiffs had accused Tellabs, a manufacturer of specialized equipment used in fiber optic networks, of making a number of overly optimistic statements about product demand and revenue growth. The Seventh Circuit held that the “strong inference” standard was met by plaintiffs’ complaint, which alleged “facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.” The Supreme Court reversed and remanded, holding that a plaintiff alleging fraud in a section 10(b) action “must plead facts rendering an inference of scienter at least as likely as any plausible opposing influence.” Justice Ginsburg, writing the majority opinion, concluded the Seventh Circuit test did not capture the stricter demand Congress sought to convey in section 21D(b)(2) of the 1934 Act, and wrote that a court must engage in a comparative evaluation; it must consider not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged . . . . To qualify as “strong” . . . , we hold, an inference of scienter must be more than merely plausible, or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.

The 2008 Stoneridge decision elaborated on the Court’s 1994 decision in Central Bank, which held that an implied cause of action under section 10(b), making unlawful deceptive conduct by any “person,” could not be extended to include background aiders and abettors, who do not themselves make the misleading statement, but may know of the primary violator’s wrongdoing and knowingly

21. The first three sentences in Justice Ginsburg’s opinion diplomatically gave perspective on the policy issues in the background of the case as follows:

This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecution and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission. . . . Private securities fraud actions, however, if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law. . . . As a check against abusive litigation by private parties, Congress enacted the Private Securities Litigation Reform Act of 1995 [PSLRA].

Justice Ginsburg cited Dabit, 547 U.S. at 81.

give substantial assistance to the wrongdoing. In the years between Central Bank and Stoneridge, plaintiffs' lawyers tried to characterize background actors as primary violators by claiming they entered into a “scheme” with the recognizable primary violator. The theory of scheme liability avoided having to show that the background person made a misleading verbal statement under the traditional version of Rule 10b-5(b) liability (making unlawful a material misrepresentation or omission) by switching to Rule 10b-5(a) and (c), which make unlawful deceptive devices and schemes or fraudulent business conduct that may not necessarily be verbal. The Supreme Court in Stoneridge rejected the attempt to turn secondary actors into primary actors by use of the word “scheme.” The case involved arrangements between a cable provider and suppliers of television set-top boxes that were essentially wash transactions but allowed the cable provider to capitalize purchases of set-top boxes, and treat offsetting payments by the suppliers for advertising as revenues, to have earnings meet projections. Justice Kennedy, writing the majority opinion, concluded that the suppliers could not be liable under section 10(b), because the plaintiffs, having no knowledge of the arrangements with the suppliers, were not able to show they relied on the misconduct of the suppliers. The opinion reasoned that the theory of scheme liability, by which the conduct of the suppliers affected the misleading revenues of the cable company, would expand the reach of the federal securities law to ordinary business operations and extend federal power beyond the immediate sphere of securities litigation into areas governed by state commercial law. Stoneridge had the effect of narrowing the range of persons who could be viewed as primary actors in a private cause of action, but it did not affect the reach of the SEC to bring enforcement actions to a wide range of wrongdoers, because the SEC is not required to show reliance.

§ 8:1.2 Antifraud Rules in State Blue Sky Laws: The Extent of Federal Preemption

Liability for fraudulent misrepresentation (deceit) emerged in the late 1700s from contract law principles governing breach of warranty. At that time, English courts began to find a person liable for inducing another to extend credit to someone known by the first person to be untrustworthy. The courts reasoned by analogy that a breach of warranty of creditworthiness had occurred, despite the fact that the representation was not being made in the drafting of a contract. In the absence of a contractual relationship governing the warranty, the courts located the source of the duty not to deceive in the inherent

reasonableness underlying common law, and they identified the interest protected by the common law as the ability to formulate business judgments without being misled by others.\footnote{24} Since the obligation not to deceive was derived from policy implicit in the common law and not pursuant to an actual contractual warranty, the common law courts early considered whether the duty not to deceive was to be analyzed comparably to the general tort duty not to cause physical harm—whether “a like liability attaches to the circulation of a thought or a release of the explosive power resident in words.”\footnote{25} If a misrepresentation involved the forseeability of physical harm, ordinary rules of negligence were said to apply, but where a misrepresentation resulted solely in economic loss, the indeterminate class of potential plaintiffs suffering indeterminate losses led courts to require intentional rather than negligent wrongdoing.\footnote{26} The common law courts accordingly developed the law of deceit separately from the law of physical injuries. In the drafting of express remedies for fraudulent conduct in the securities laws, Congress, in turn, modified the common law of deceit to conform the express remedies to the policy considerations behind the securities laws.\footnote{27}

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\item[24.] Harper, James, and Gray state that “[g]enerally the law of deceit is limited to misrepresentations that lead another into an unwise judgment in some business enterprise resulting in financial loss.” \textit{Id.} at 378 [citing United States Nat’l Bank v. Fought, 291 Or. 201, 220, 630 P.2d 337, 348 (1981)].
\item[25.] Ultramares Corp. v. Touche, 255 N.Y. 170, 181, 174 N.E. 441 (1931) [Cardozo, J.].
\item[26.] \textit{Id.}, 225 N.Y. at 179. \textit{See also} Bohlen, \textit{Misrepresentation As Deceit, Negligence or Warranty}, 42 HARV. L. REV. 733 (1929) [recognizing that various situations of misrepresentation may lead to strict liability, liability for negligent wrongs, and liability for intended wrongs]. The requirement of an intention to deceive was not affirmed expressly until late in the nineteenth century. The doctrine was stated in the decision of the House of Lords in Derry v. Peek, 14 App. Cas. 337, 374 (H.L. 1889), which involved misrepresentations made in a company’s prospectus concerning the company’s right to use power vehicles rather than horses. Finding no liability, the court held that for there to be deceit, it must be established “that a false misrepresentation has been made [1] knowingly, or [2] without belief in its truth, or [3] recklessly, careless whether it be true or false.” Harper, James & Gray, \textit{supra} note 23, at 392 [quoting Derry V. Peek, 14 App. Cas. 337, 374 (H.L. 1889)]. The requirement of intent to deceive generally has been referred to in the law as “scienter.”
\item[27.] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The securities laws reflect the ability of the law of deceit to be modified on the basis of context. Section 11 of the 1933 Act, which imposes liability for misstatements or omissions in a registration statement, changes the standard of care from strict liability [for issuers] to negligent liability [for directors, underwriters, etc.] depending on the defendant. The 1934 Act also alters the applicable standard. In section 9(e), the conduct of the defendant [manipulation], rather than the class of defendant, determines whether a “willful” standard will be applied. In section 18, attention shifts from mental culpability to
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\end{footnotesize}
Under common law principles, deceit is a misrepresentation that is fraudulent.28 A person is exposed to liability for deceit for (1) fraudulently making (2) a false representation (3) with the intention of inducing another to rely thereon. If (4) the misrepresentation induces reliance, (5) the reliance is justified, and (6) the misrepresentation causes damage, the defendant is liable.29 Reliance on a fraudulent misrepresentation is not justifiable unless (7) the matter misrepresented is material.30

Both the federal courts, interpreting Rule 10b-5, and the state courts, interpreting their antifraud rules, occasionally refer to the common law of deceit for guidance. Thus, the Supreme Court in *Dura*, summarized above, looked to common law for precedent on the necessity for plaintiff to prove loss causation (item 6 in the preceding paragraph). The antifraud rules in many states are based on the Uniform Security Act, which is described later in this section. Since 1956, the antifraud rule in the Uniform Security Act has been modeled on Rule 10b-5 and section 17(a) of the 1933 Act. The definition section of the Uniform Security Act provides that the terms “fraud,” “deceit,” and “defraud” are not limited to common law deceit. The overall result is that antifraud rules that may appear similar to Rule 10b-5 and section 17(a) are likely to have widely varying interpretations.

State securities antifraud laws, commonly known as blue sky laws,31 were crafted, in part, from the common law of deceit, but in addition to antifraud rules, the blue sky laws required a merit analysis of an investment before certain securities could be offered for sale within the borders of the state. Unlike the full disclosure approach of the 1933 Act, the states had established a merit policy of full review of the falsity of the statement in a 1934 Act report. Section 10(b) refers to "deceptive" conduct and, therefore, in implying a cause of action thereunder, the courts have shown a propensity to return to the elements in the common law action of deceit.

28. See Restatement (Second) of Torts, scope note topic 1, ch. 22 (Fraudulent Misrepresentation [Deceit]) [1977].
29. See Restatement (Second) of Torts § 525 [1977].
30. Restatement (Second) of Torts § 538 [1977].
31. The first reference to the term “blue sky law” in federal courts appears to be the Supreme Court opinion of Justice McKenna, upholding the constitutionality of the Ohio blue sky law in *Hall v. Geiger-Jones*, 242 U.S. 539 [1917], in which he wrote:

The name that is given to the law indicates the evil at which it is aimed, that is, to use the language of a cited case, “speculative schemes which have no more basis than so many feet of ‘blue sky’; or, as stated by counsel in another case, “to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines and other like fraudulent exploitations.”
the quality of the security. First enacted in 1911, there were blue sky laws in every state except Nevada by the time Congress drafted the 1933 Act. Twenty years of state regulation preceded the 1933 Act, and federal regulation was partially to remedy defects in blue sky laws because they did not apply to securities offered across state lines.\textsuperscript{32} Despite any shortcomings in the blue sky laws, both the 1933 Act and the 1934 Act contained explicit savings clauses that preserved state authority over securities matters.

By 1996, issues of efficiency in capital formation had overcome policy considerations for the dual system and lingering political or constitutional issues. Congress passed the National Securities Markets Improvement Act of 1996 (NSMIA) that reversed the sixty-three-year pattern of concurrent state and federal regulation, and explicitly preempted significant portions of the blue sky law regulation and reporting requirements applicable primarily to intrastate transactions in securities. NSMIA appears in section 18(a) of the 1933 Act, which exempts from state law registration or qualification requirements any security that is a “covered security” as defined in section 18(b).

Covered securities include certain stock exchange listed securities, registered 1940 Act companies, securities sold to “qualified purchasers” as defined by the SEC, and specified exempt securities. The exempt securities include section 3[a] securities, other than section 3[a][4], 3[a][10], or 3[a][11] securities, but a section 3[a][2] exempt municipal security “is not a covered security with respect to the offer or sale of such security in the State in which the issuer of such security is located.” Covered securities also include securities in section 4(2) exempt transactions, notably Rule 506 of Regulation D safe harbor transactions.\textsuperscript{33} Covered securities, however, are not exempt from the limited notice filing requirements.\textsuperscript{34}


\textsuperscript{34} Section 18(c)(2)(A) of the 1933 Act provides:

\textit{Notice Filings Permitted.} Nothing in this section prohibits the securities commission [or any agency or office performing like functions] of any State from requiring the filing of any document filed with the Commission pursuant to this title, together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the state [if such sales data is not included in documents filed with the Commission], solely for notice purposes and the assessment of any fee, together with a consent to service of process and any required fee.
Section 18(c) has a savings clause for the antifraud provisions of state blue sky laws:

*Fraud Authority.* Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

Despite the fact that the blue sky law antifraud rules predate the federal securities laws, it was the case that, prior to PSLRA, private civil actions under state and federal securities laws were generally brought under the 1933 and 1934 Acts to enforce federal private rights of action, particularly class action cases involving publicly traded companies. Pendant state law claims were often included in federal complaints, but the primary effort was directed at the federal claim. Federal courts have exclusive jurisdiction in Rule 10b-5 actions, and the implied fraud-on-the-market exception to the reliance requirement is available in a Rule 10b-5 case, but the theory has not been widely adopted by states under state antifraud rules. The fraud-on-the-market theory facilitates class certification and the certification of a larger class than would be permitted if the presumption were not available.36

There was an abrupt shift in tactics by plaintiffs' lawyers after Congress enacted PSLRA in 1995. The House Conference Report accompanying PSLRA identified ways in which the class action device was being used to injure “the entire U.S. economy.”37 According to the Report, nuisance filings, targeting of deep pocket defendants, vexatious discovery requests, and “manipulation by class action lawyers of the clients whom they purportedly represent” had become rampant. Proponents of PSLRA argued that these abuses resulted in extortionate settlements, chilled any discussion of issuers’ future prospects, and deterred qualified people from serving on boards of directors.38

PSLRA created a set of procedural hurdles in order to make it more difficult for plaintiffs’ lawyers to bring and maintain class action litigation in federal court.39 In effect, PSLRA established a subset of the Federal Rules for Civil Procedure applicable only to securities fraud cases. Based on a Congressional determination that Rule 9(b) of the

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38. *Id.* at 31–32.
Federal Rules, which requires specificity in pleading, had failed to stem abusive lawsuits, the heightened pleading standard for a securities law complaint requires (1) that when a complaint is pleaded on information and belief, it must state “with particularity all facts on which that belief is formed,” and (2) that the complaint “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” A particular grievance of defendants was the use of discovery procedures, prior to a hearing on a motion to dismiss, as a means of increasing litigation expenses on defendants to pressure settlement. PSLRA mandates a stay of discovery while a motion to dismiss is pending. As discussed in Dura, PSLRA provides that the plaintiff has the burden of proving loss causation. Finally, PSLRA, to counteract litigation based on forward-looking statements that turn out to be mistaken, provides a safe harbor for forward-looking statements identified as such, and made with “cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.”

Looking back in 2006, Justice Stevens in his majority opinion in Dabit summarized the unintended consequences of PSLRA:

But the effort also had an unintended consequence: It prompted at least some members of the plaintiffs’ bar to avoid the federal forum altogether. Rather than face the obstacles set in their path by the [PSLRA], plaintiffs and their representatives began bringing class actions under state law, often in state court. The evidence presented to Congress during a 1997 hearing to evaluate the effects of the [PSLRA] suggested that this phenomenon was a novel one; state-court litigation of class actions involving nationally traded securities had previously been rare.

Congress concluded that the policy underlying PSLRA was being frustrated by the record number of securities actions being filed in state courts, and in 1998 Congress enacted the Securities Litigation

40. See 1934 Act, section 21D(b)(1). The requirement applies to private actions containing allegations of a misleading statement of a material fact or an omission to state a material fact.
41. See 1934 Act, section 21D(b)(2). The requirement applies to any private action in which plaintiff may recover money damages only on proof that defendant acted with a particular state of mind. See Tellabs, Inc. v. Makor Issues & Rights Ltd., 541 U.S. 308 (2007).
42. See 1934 Act, section 21D(b)(3).
43. See 1934 Act, section 21D(b)(4).
44. See 1934 Act, section 21E(c). The safe harbor applies to issuers subject to the 1934 Act reporting requirements.
Uniform Standards Act (SLUSA) to give federal courts exclusive jurisdiction over certain securities class actions. Federal preemption under SLUSA applies to “covered class actions,” which are made removable to the federal district court for the district in which the action is pending. Covered class actions are class actions in which damages are sought on behalf of more than fifty persons in connection with misrepresentation or omission of a material fact, or deceptive conduct, in connection with the purchase or sale of a “covered security.” A covered security is defined by cross-reference to the definition in NSMIA incorporated into section 18(b) of the 1933 Act, but not all NSMIA covered securities are SLUSA covered securities. The incorporation into SLUSA is limited to the covered securities defined in paragraph (1) or (2) of section 18(b). Paragraphs (1) and (2) refer to certain exchange-traded securities and 1940 Act registered investment companies. Section 3(a)(2) exempt municipal securities are referenced in paragraph (4) of section 18(b), and therefore the SLUSA preemption provisions do not ordinarily apply to class actions brought in state courts for misleading statements or deceptive conduct in connection with the purchase or sale of municipal securities. In addition, the definitional cross-reference in section 28(f)(5)(E) of the 1934 Act specifically excludes from preemption a security that is exempt from 1933 Act registration by reason of the private placement section 4(2) exemption.

A possible exception to the nonapplication of SLUSA to municipal securities is a private activity bond that is guaranteed by a corporation that has corporate debentures listed on one of the exchanges. Paragraph (1) of the section 18(b) list of covered securities references in subparagraphs (A) and (B) the exchanges that are included in the definition, and subparagraph (C) refers to “a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraphs (A) and (B).” Thus, if corporation XYZ lists general unsecured debentures on an exchange, and corporation XYZ issues a general unsecured guaranty on a private activity bond, the SLUSA preemption arguably applies.

To summarize, class actions in connection with the purchase or sale of numerous types of municipal securities are preserved for state court jurisdiction to apply the state blue sky law antifraud rules. There is significant variation in the statutory language making fraudulent conduct unlawful. For example, the New York statute, the Martin Act, does not allow a private cause of action. Many states, however, have adopted one of the versions of the Uniform Securities Act. The

47. See 1934 Act, section 28(f).
National Conference of Commissioners on Uniform State Laws in 2002 released a revised version of the Uniform Securities Act to modernize the Uniform Securities Act of 1956 and the Revised Uniform Securities Act of 1985 as a consequence of then recent federal preemptive legislation (NSMIA and SLUSA), technological changes in securities trading and regulation, and increasing numbers of securities transactions that had interstate and international aspects. Section 501 of the 2002 Uniform Act, which had been section 101 of the 1953 Uniform Act, provides as follows:

It is unlawful for a person, in connection with the offer, sale, or purchase of a security, directly or indirectly:

1. to employ a device, scheme, or artifice to defraud;
2. to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading; or
3. to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.

Unlike the judicially created implied civil action under section 10(b) of the 1934 Act, the 2002 Uniform Act follows section 501 with a series of enforcement and remedial sections, depending on the person initiating the action. Section 509 addresses civil liability, and section 509(a) recognizes the preemptive effect of SLUSA for class actions related to covered securities. Section 509(b) addresses liability of sellers to purchasers as follows:

**Liability of seller to purchaser.** A person is liable to the purchaser if the person sells a security . . . by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the purchaser not knowing the untruth or omission and the seller not sustaining the burden of proof that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission . . . .

Section 509(b) of the 2002 Uniform Act illustrates the variations in federal and state antifraud rules, despite the fact that section 501 is drafted from Rule 10b-5 and section 17(a). Unlike the current standards on implied rights of action under Rule 10b-5, neither causation nor reliance has been held to be an element of a private cause of
action under the precursor to section 509(b). 48 On the other hand, section 509(b) superimposes on section 501 a type of privity requirement similar to section 12[a][2] of the 1933 Act, although it is broader than the section 12[a][2] restriction to sales “by means of a prospectus.” 49 Interpretation of section 501 of the 2002 Uniform Securities Act requires reference to the specific remedial sections after section 501, and appropriate state case law.

§ 8:2 Antifraud Rules in Tender Offers for Municipal Securities

Before considering the elements of a cause of action in a section 10(b) case or in an SEC enforcement action under section 17[a] of the 1933 Act, it is worth reviewing the tender offer antifraud provision in section 14(e) of the 1934 Act, because section 14(e) highlights some boundaries of the other two antifraud rules. Section 17[a] of the 1933 Act covers fraud in the “offer or sale of any securities,” and was intended to apply primarily to the relevant time period when new issue securities are offered and sold in a distribution or a private placement, but the wording does not specifically limit the rule to the new issue market. Section 10(b) and Rule 10b-5 cover fraud “in connection with the purchase or sale of any security,” and section 10(b) was intended to apply to trading activity in the marketplace, but the term “sale” includes new issue sales in a distribution or private placement. Section 14(e) covers fraud “in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request or invitation.”

Each of the three antifraud rules has its own time period during which there cannot be misleading information disseminated to investors or potential investors. For secondary market transactions, Rule 10b-5 generally applies to the time of trade, whereas section 14(e) comes into play at the time a tender offer is communicated, which may be weeks before the actual trade occurs. If there is a tender offer contemplated, the issuer and its agents will determine whether there are any misstatements or omissions material to the offerees of the tender at the time the tender offer is made.


49. See Official Comment 3 to section 509 of the 2002 Uniform Securities Act.
A second distinguishing feature of section 14(e) is that the provision expressly grants the SEC authority to adopt rules and regulations not only to define fraud in connection with a tender offer, but also to “prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.” There is no comparable preventive authority granted under section 10(b). Rule 10b-5 is thus limited to defining fraud, whereas there are extensive tender offer rules governing the procedures for making tender offers. The absence of similar language in section 10(b) precludes the SEC from adopting rules governing disclosure practices of issuers selling municipal securities. In public finance, the regulatory approach of the SEC with respect to issuer new issue disclosure is, to a large extent, limited to enforcement actions for prior violations of the antifraud rules, and does not include rules to prevent, prospectively, fraud in the making of disclosure.

The scope of authority for the SEC to adopt tender offer rules was an issue in the insider trading case, United States v. O’Hagan, discussed below in the section on insider trading of municipal securities. Defendant was a law firm partner who accessed information in the firm that a firm client was about to make a tender offer. The partner began purchasing shares and options in the target company. Among the counts in the indictment was a charge that O’Hagan engaged in fraudulent trading in connection with a tender offer in violation of section 14(e) of the 1934 Act. O’Hagan argued that the SEC’s Rule 14e-3 controlling trading during a tender offer was outside the SEC’s authority. Writing for the majority, Justice Ginsburg separated the first two sentences of section 14(e) for purposes of analysis:

> It shall be unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Justice Ginsburg noted that the first sentence is drafted similarly to section 10(b) of the 1934 Act, except that the first sentence is self-executing and does not require a rule (comparable to Rule 10b-5) of the SEC to define fraudulent acts or practices. The second sentence authorizes SEC rules, but is drafted similarly to section 15(c)(2) insofar as it allows preventive rules, and the Court therefore rejected O’Hagan’s argument that Rule 14e-3 (a disclose-or-abstain-from-trading rule) was beyond the SEC’s power.

§ 8:2.1 Application of SEC Tender Offer Rules to Municipal Securities

A conventional tender offer is a publicly made invitation addressed to all holders of a class of securities of an issuer to tender their securities for sale at a specified price. Cash or other securities may be offered as consideration, and the amount of consideration specified is usually at a premium over the current market price of the securities. The opportunity to tender securities at the specified price remains open only for a limited period of time. If fewer than the stated number are tendered, the offeror is not required to purchase any of the tendered securities, and if there is more than the stated amount, the offeror is not required to purchase the excess. After the security is tendered by a holder, the security is held in escrow with a depositary until it is determined if the offeror receives the required amount of securities.51

Prior to the 1960s, tender offers were used primarily by issuers as a means of repurchasing their own securities, but in the 1960s cash tender offers became a common feature of takeovers by outsiders. Congress found it necessary to legislate procedures for takeover contests to gain corporate control, and the SEC embarked on rulemaking that is frequently updated in response to new methods by third-party takeover specialists and the targeted company. In public finance, a tender offer is generally used for nontakeover purposes and often as a part of a plan to restructure the issuer’s outstanding debt. For example, an issuer of fixed interest rate bonds may determine in a period when the bonds are not subject to optional redemption that it would be appropriate to convert a portion of the outstanding bonds to variable-rate bonds. A tender offer is made and, if a sufficient amount of bonds is tendered to make the conversion practicable, bonds are reissued as variable-rate debt.

The Williams Act makes unlawful certain conduct relating to tender offers, most notably in the context of cash takeover attempts.52 At the time of enactment of the Williams Act, an attempt by one company to seek control of another by means of a stock-for-stock exchange subjected the offer to the registration requirements of the 1933 Act. Likewise, attempts to control a company through a proxy contest were subject to the proxy rules under the 1934 Act. Prior to 1968, however, takeover attempts by cash tender offers required no filings or preparation of information for shareholders. The purchase or sale requirement under Rule 10b-5, discussed above, precluded an

offeree from bringing a fraud action in a tender offer unless there was an actual purchase or sale by the offeree.

Congress concluded in 1968 that cash tender offers were similar to proxy contests and the difference in regulation was unwarranted. In considering the application of tender offer rules to public finance, it should be recognized that the purpose of the Williams Act was to provide for full disclosure in connection with cash tender offers and related techniques for accumulating large blocks of equity securities in publicly held companies. The legislation was designed primarily to close gaps in the regulation of corporate takeovers.

The Williams Act amended section 13 of the 1934 Act by adding subsection (d) to require the filing of a statement by any person who acquires beneficial ownership of more than 5% of a class of securities. The statement must disclose the size of holdings, sources of funds, and any plans to liquidate the company if control is acquired. Section 13(d) specifically applies to equity securities of a class registered pursuant to section 12 of the 1934 Act and therefore does not apply to municipal debt securities.

Prior to the Williams Act, section 14 of the 1934 Act was limited to the regulation of proxy contests. Section 14(a) applies to proxies in respect of any security but specifically excepts exempted securities as defined in section 3(a)(12) of the 1934 Act. Municipal securities are exempted securities and therefore are not within the scope of the proxy rules. The Williams Act added section 14(d) which, like section 13(d), applies to equity securities registered under section 12 of the 1934 Act and does not include municipal debt securities. Section 14(d) delegates to the SEC authority to regulate in detail the various aspects of tender offer solicitations and recommendations by persons other than the offerors.

Despite the declared purpose of the Williams Act to regulate corporate takeovers by cash tender offers for equity securities, the legislation added section 14(e) to the 1934 Act, a section drafted to apply an antifraud rule to tender offers for any securities. The section 14(e) tender offer antifraud rule is not limited to equity securities and does not make an exception for exempted securities. Section 14(e) is therefore drafted to include municipal securities within its scope. Any misstatement or omission of a material fact “in connection with any tender offer” is prohibited.\(^5^4\) Section 14(e) specifically

\(^{53}\) Id.

\(^{54}\) Section 14(e) is as follows:

\[e\] It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading,
applies to the offer as well as a purchase or sale covered by Rule 10b-5. As stated above, the antifraud provisions of Rule 10b-5 test the quality of disclosure at the time of sale, and section 14(e) enlarges the time frame to include the time of the offer as well as the sale. In addition, section 10(b) limits SEC rules to defining fraud while section 14(e) confers on the SEC the authority to prescribe means to prevent fraudulent acts or practices in connection with tender offers.\textsuperscript{55}

Sections 14(d) and 14(e) provide the SEC with extensive rulemaking power. The rules under section 14(d) are grouped into Regulation 14D and those under section 14(e) are set forth in Regulation 14E. Regulation 14D provides a regulatory trigger for the commencement of a tender offer, regulates the content of information, and requires procedures for the dissemination of information. Regulation 14E continues the detailed requirements of Regulation 14D but relies on the antifraud jurisdictional basis of section 14(e). For example, as a means reasonably designed to prevent fraudulent practices, Rule 14e-1 requires tender offers to be held open for at least twenty days, and Rule 14e-2 regulates the responses of subject companies requiring the company within ten business days of the tender offer to publish a statement setting forth its position on the offer.

The rules under section 14(e), initially adopted in 1979, are so broad that, on their face, they apply to any securities. The context of the drafting, however, clearly indicates that the Regulation 14E rules were designed to supplement and continue the regulatory process set forth in Regulation 14D that applies to cash tender offers of equity securities. The SEC Release accompanying the adoption of Regulation 14E limits its jurisdictional scope by stating that “Regulation 14E does not apply to any tender offer for ‘exempted securities’ as that term is defined in section 3(a)(12) of the Exchange Act,”\textsuperscript{56} and Rule 14d-1 provides that “Regulation 14E shall apply to any tender offer for securities (other than exempted securities) unless otherwise noted

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or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.


It follows that the antifraud provisions of the statute itself apply to tender offers for municipal securities, but that the SEC had not considered Regulation 14E to control tender offers for municipal securities. Under the statute, however, the SEC has the power to adopt detailed rules to prevent fraudulent practices in the conduct of tender offers for municipal securities if it so chooses or to reconsider the applicability of Regulation 14E to municipal securities. 57

A reading of Rule 14d-1 leads to the conclusion that the section 14(d) rules (Regulation 14D) are not applicable to municipal securities because section 14(d) applies to equity securities, and the section 14(e) rules (Regulation 14E) do not apply because Rule 14d-1 states that Regulation 14E does not apply to “exempted securities” unless otherwise noted therein. There are two important precautions to this result. First, not all securities in public finance are technically “municipal securities” and thus included in “exempted securities,” as those terms are defined in the 1934 Act. As explained in chapters 1 and 2, taxable private activity bonds are not technically municipal securities; certificates issued by a tender option bond trust, into which municipal securities are deposited, are ordinarily not municipal securities; and there is some controversy about the proper categorization of other “municipal” securities. Second, municipal tender offers are often conducted by a broker-dealer acting as agent for an issuer, and broker-dealers are subject to MSRB fair dealing rules. Broker-dealers making tender offers should at least be familiar with the main themes of Regulation 14D and Regulation 14E in determining the fair dealing rules broker-dealers will apply to a tender offer for municipal securities.

§ 8:2.2 The Meaning of a Tender Offer

The 1934 Act does not define the term “tender offer,” and although the SEC has detailed rules for defining when a tender offer commences, the SEC has elected not to define a tender offer, preferring flexibility to respond to activities that function as unconventional tender offers. 58 The SEC has, however, identified factors that it believes should be considered in determining whether there is a tender offer, 59 and these factors, along with court decisions, were distilled by

57. Unlike § 10(b) of the 1934 Act, which is not self-executing and requires SEC rules, § 14(e) is self-executing and will support a cause of action without any applicable SEC rules. Section 14(e) has been held to provide a private right of action. See, e.g., Dyer v. E. Trust & Banking Co., 336 F. Supp. 890 [D. Me. 1971].


the district court for the Southern District of New York in 1979 as follows:

- active and widespread solicitation of public shareholders for the shares of an issuer;
- solicitation made for a substantial percentage of the issuer’s stock;
- offer to purchase made at a premium over the prevailing market price;
- terms of the offer are firm rather than negotiable;
- offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;
- offer open only for a limited period of time;
- offeree subjected to pressure to sell the stock; and
- public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target company’s securities.\(^{60}\)

When it is concluded that a solicitation constitutes a tender offer for municipal securities, and not a trade or other privately negotiated transaction, the applicable concepts of material misstatements or omissions under section 14(e) are comparable to the antifraud rules and section 10(b).\(^ {61}\) If holders tender securities in circumstances in which they would not have tendered if the facts were properly represented, there is a basis for a section 14(e) action.\(^ {62}\) It follows that an offering memorandum for a tender offer should be drafted with standards similar to those used in the preparation of an official statement for a new issue offering, but with information limited to what is appropriate in the context of a decision whether to tender.

The *Wellman* formulation has been followed by other courts, including the Ninth Circuit in *SEC v. Carter Hawley Hale Stores, Inc.*,\(^ {63}\) where it was emphasized that not all the *Wellman* factors need be present for there to be a tender offer. Ten years after *Wellman*, the Second Circuit recognized the relevance of the *Wellman* factors, but held that a broader functional test, which focuses on the investors’ need for information, was appropriate:

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63. *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985).
The question of whether a solicitation constitutes a “tender offer” within the meaning of § 14(d) turns on whether, viewing the transaction in the light of the totality of circumstances, there appears to be a likelihood that unless the pre-acquisition filing strictures of that statute are followed there will be a substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal put before them.64

The issue of the existence of a tender offer frequently arises when an issuer retains a broker-dealer to purchase outstanding securities on its behalf in the open market. Lawyers are likely to consider the Wellman factors and the functional test in advising whether the proposal involves ordinary secondary market negotiated trades or a tender offer. Thus, if an issuer (with its outstanding municipal securities trading at 90) requests a broker-dealer to purchase up to $25 million of its outstanding $100 million securities in a price range of 90 to 93 by negotiating with individual holders, there is no tender offer. In fact, a willingness to buy any amount of its outstanding securities should not be considered a tender offer if each trade is separately negotiated at a market price. When, however, the issuer instructs the broker-dealer to offer 91 to all outstanding holders, and conditions all offers on acceptances of investors with securities totaling $75 million, there is probably a tender offer. In the first situation of individually negotiated trades, ordinary Rule 10b-5 standards apply, and in the second situation, section 14(e) is likely to be applied to require information to inform investors adequately whether to accept the tender. Section 14(e) is available to investors who choose not to respond; Rule 10b-5 is available to investors who decide to sell.

The word “tender” is frequently used without any implication of a tender offer under section 14 of the 1934 Act. In the context of variable-rate bonds, there are optional and mandatory tenders by holders of the securities, but these tenders do not implicate section 14. Likewise, tender option bond provisions do not create section 14 tender offers. And, if a broker-dealer happens to have a portfolio of a large block of an issuer’s securities and “tenders” the securities to the issuer, there is not a tender offer as the term is used in section 14. These transactions are subject to antifraud rules, but the more appropriate rule is Rule 10b-5.

Finally, it should be recognized that a tender offer is not limited to a cash-for-securities transaction. An exchange offer can be cast in the form of a tender offer. Thus, if all holders of outstanding Series A Bonds of an issuer are offered an equivalent amount of Series D Bonds proposed to be issued if a stated percentage of Series A holders agree,  

64. Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 57 (2d Cir. 1985).
Section 14(e) should be the relevant antifraud rule to evaluate disclosure of the exchange offer. In this case, material disclosure would include the plan of finance, the terms of the exchange offer, including the consequences of not agreeing to the exchange, material differences between the Series A and Series D Bonds, and disclosure about the Series D Bonds, probably the equivalent of a new issue official statement.

§ 8:2.3 Fraud in Tender Offers

Section 14(e) is drafted to require that tender offerors give holders of securities adequate information in making a decision in response to the tender offer. The Supreme Court has stated that “[t]he purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information.”65 The problem addressed by the Williams Act was summarized in Congress prior to enactment of the statute: “Today, the public shareholder in deciding whether to accept or reject a tender offer possesses limited information. No matter what he does, he acts without adequate knowledge to enable him to decide rationally what is the best course of action.”66 These statements are clear indicators of the authority for SEC rules to regulate tender offers and the appropriate interpretation of the section 14(e) antifraud rule. The maker of a tender offer is to provide security holders with material information, at the time of the tender offer, that is relevant to making an informed decision whether to accept or reject the offer. It is in this context that any material misstatements or omissions are to be evaluated.

The rule makes it unlawful for “any person” to make any untrue statement of a material fact or omit to state any material fact in connection with any tender offer. “Any person” can refer to the issuer, a broker-dealer, a financial advisor, an institutional investor making a tender offer, or others, and, in a takeover contest, will be each of the rival contestants for shares in the target company. Like section 10(b) and Rule 10b-5, there is no express cause of action in section 14(e), but investors who are the offerees of a tender offer have an implied cause of action because they are the intended beneficiaries of the Williams Act.67

There are extensive tender offer rules of the SEC governing the conduct of tender offers, but when section 14(e) is separated from

those rules and considered by itself, as in the case of most tender offers for municipal securities, section 14(e) is a disclosure rule. Taken alone, section 14(e) is neutral as to the conduct of the contestants in a takeover tender offer and the fairness of the amount in the offer. If there are no material misstatements or omissions in the tender offer disclosure, courts will not use section 14(e) to evaluate the terms of the offer or procedural matters. The Supreme Court rejected an effort to apply section 14(e) to review the fairness of procedures by concluding: “Nowhere in the legislative history is there the slightest suggestion that 14(e) serves any purpose other than disclosure.”\textsuperscript{68} The Court quoted the sponsor of the legislation in the Senate and stated: “The process through which Congress developed the Williams Act also suggests a calculated reliance on disclosure rather than court-imposed principles of ‘fairness’ . . .”\textsuperscript{69} Below, there is a consideration of MSRB principles of fair-dealing under MSRB Rule 17, and their application to tender offers for municipal securities, but these are municipal broker-dealer obligations derived from MSRB rules and not implied obligations under the section 14(e) disclosure rule. The meaning of section 14(e) was succinctly stated by the Second Circuit:

In sum, and put as simply as possible, the standard for determining liability under § 14(e) on the part of a person making a misleading tender offer, or a responsible officer of a corporation making such an offer, is whether plaintiff has established that defendant either (1) knew the material facts that were misstated or omitted, or (2) failed or refused to ascertain such facts when they were available to him or could have been discovered by him with reasonable effort.\textsuperscript{70}

\section*{§ 8:2.4 MSRB Fair Dealing Rules Applicable to Municipal Tender Offers}

The Supreme Court characterized section 14(d) and section 14(e) as disclosure rules, and cited legislative history to the effect that the statute is not an invitation for court review of the fairness of the offer. Nevertheless, the SEC in Regulation 14D and Regulation 14E has imposed lengthy rules to assure that investors will be treated equally and fairly. These competing policies may be reconciled by inferring that courts are not to review the substantive fairness of a tender offer, such as the price offered, but it is appropriate for the SEC to adopt procedural rules of fair treatment of investors to assure investors will

\textsuperscript{68} Id. at 11.
\textsuperscript{69} Id. at ___, n.8.
\textsuperscript{70} Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 364 (1973).
be able to respond in a rational manner as to the best course of action. For example, Rule 14d-8, supplementing section 14(d)(6), requires pro rata acceptance of shares tendered where the tender offer, by its terms, allows partial acceptances and does not require the tender offeror to accept all securities tendered. The rule prevents investors from being pressured into making a hasty decision without the opportunity to engage in an adequate review of the disclosure material. Rules to prevent a pressured decision are inherent in the idea of adequate disclosure.

Tender offers for municipal securities are normally initiated by an issuer retaining a broker-dealer to manage the tender offer. Broker-dealers are subject to MSRB Rule G-17, which requires them in the conduct of their municipal securities activities to deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practices. The question for the broker-dealer is whether it should interpret Rule G-17 as a backdoor opening for the imposition of Regulation 14D or Regulation 14E rules that could be considered fair dealing rules in the context of a municipal tender offer. As a general practice, the municipal bankers retained to manage a municipal tender offer should review the procedures with the firm's compliance or legal department to resolve any procedures that may be problematic. The competing principle is that the issuer may be making the tender offer, with the broker-dealer acting as agent, and the issuer is not subject to MSRB Rule G-17, but only to the disclosure obligation of section 14(e).

Two tender offer rules may be useful in considering the application of MSRB Rule G-17. Rule 14e-3 makes it unlawful for any person who is in possession of material nonpublic information relating to the tender offer and received from the issuer, to purchase or sell for its own account any of the securities that will be subject to the tender. The prohibition applies before the tender offer is made if the issuer has “taken a substantial step” toward making the tender, and the SEC drafted the rule to cover not only insiders subject to Rule 10b-5, but also persons who may not have a duty to speak after Chiarella. As a matter of fair dealing under MSRB Rule G-17, the broker-dealer should avoid trading on nonpublic information in contemplation of a tender offer, regardless of the direct binding effect of Rule 14e-3. Parallel trading covered by Rule 14e-5 for certain covered persons should be reviewed in the tender offer context under G-17 as well as any other activities designed to benefit the broker-dealer trading for its own account that might be detrimental to tender offerees.

A different conclusion may apply to rules established by the issuer that might not be permitted if Regulation 14D or Regulation 14E were
in effect. For example, Rule 14e-1 requires that any person making a
tender offer must hold the offer open for at least twenty business days
from the date upon which it was first published. The rule was drafted
in response to takeover bids in which investors need adequate time to
consider which management is to control the company. It is unlikely
that a municipal tender offer involving only a decision to sell or hold
securities requires a comparably long period, and if the issuer chooses
a shorter period, there should be no Rule G-17 obligation on the
broker-dealer to insist on the longer period. A more difficult case is
presented by Rule 14d-10, the equal treatment and best price rule.
Rule 14d-10 precludes any tender offer unless:

1. The tender offer is open to all security holders of the class of
   securities subject to the tender offer; and

2. The consideration paid to any security holder pursuant to the
tender offer is the highest consideration paid to any other
security holder during such tender offer.

This rule clearly speaks to fairness, but the issuer making the bid may
have valid reasons to extend the tender offer to a limited group of
holders and possibly to have criteria for different prices. The fairness
issue can be overcome by adequate disclosure pursuant to section 14(e)
clearly stating the ground rules. The broker-dealer is not engaging in
self-dealing trading activity and should not be precluded from acting as
the issuer’s agent by reason of Rule G-17. A more difficult case under
Rule G-17 is presented if the broker-dealer is the tender offeror, acting
as a principal, and is the person establishing ground rules with
unequal treatment and prices.

§ 8:2.5 Drafting Tender Offer Disclosure

The purpose of a tender offer disclosure document is to provide
investor offerees with material facts to inform investors adequately so
that they can intelligently decide how to respond to the tender offer.
Accordingly, the tender offer circular is drafted and delivered at the
commencement of the tender offer period. Disclosure for a tender offer
should be distinguished from new issue disclosure. In a new issue, a
potential investor is deciding whether to purchase the securities of an
issuer, and disclosure will include complete information about the
issuer and the offering contained in an official statement. In a tender
offer, the investor owns the securities, presumably knows the issuer
and key information about the security, and disclosure will be focused
on whether the investor should sell the securities pursuant to the
tender offer. Key facts to be disclosed are the terms of the offer and the
consequences of either accepting or rejecting the offer. Assuming that
the tender offeror is the issuer of the securities, topics for consideration in drafting the disclosure include:

- Identification of securities subject to the tender, and CUSIP numbers.
- Specific terms of the offer, e.g., total principal amount, maturities, the price offered, expiration of the offer, the method for accepting the offer, the date and procedures for payment.
- The issuer’s plan of finance leading it to make the tender offer and source of funds for payment.
- Whether the offer may be extended beyond the announced expiration date and procedures for extension.
- Whether the offeree has the right to withdraw an acceptance, the time period, and procedures.
- If the tender offer is for less than all of the bonds of a maturity, the procedures for selecting bonds in the event there is an oversubscription.
- Conditions for the tender offer, such as the minimum amount of bonds that must be tendered, by maturity, for the tender offer to proceed.
- Whether the tender is conditioned on the successful offering of an issue of bonds.
- Rights of the issuer to withdraw the tender.
- Any fees payable by offerees in connection with the tender.
- Information on the required or expected future redemption of bonds not tendered.
- Update of information about the issuer material to the decision since the date of the official statement or filed continuing disclosure, and the Internet or other location of the official statement and information about the issuer and the subject securities.

In many cases, the tender offer will relate to a proposed new issue of securities, either for new money or a refunding to provide a source of funds to pay for the tendered bonds and any redemption of bonds. The tender offer disclosure document can then be attached to the preliminary official statement for the new issue. It will be necessary for the period of time between the mailing of the preliminary official statement and the sale date to be sufficient to allow the tender offerees to have adequate time to make an informed decision. It will also be necessary to highlight the tender offer in the preliminary official statement, perhaps with a cover sheet indicating that it incorporates a tender offer, and to arrange delivery of the package to the tender
offerees. Using this procedure allows the issuer to draft a plan of finance section for both the tender offerees and the potential investors in the new securities. When the final official statement is prepared, the tender offer attachment is removed, and the plan of finance section is updated to show the outcome of the tender offer. The pattern of disclosure for each tender offer will depend on the circumstances, but should in every case take into consideration the guiding purpose of section 14(e) to assure that investors have adequate information to make an intelligent decision.

§ 8:3 Antifraud Jurisdiction: The Reach of Rule 10b-5

§ 8:3.1 Standing: Purchaser-Seller Requirement

[A] Birnbaum Rule and Oral Contracts

In 1946, the federal district courts first began finding an implied civil liability under Rule 10b-5.\(^{71}\) Six years later, in *Birnbaum v. Newport Steel Corp.*,\(^{72}\) the Second Circuit determined that a person who was not a purchaser or seller of a security could not maintain an action under Rule 10b-5. The so-called *Birnbaum* rule limiting the class of potential plaintiffs was based on the express language of section 10(b) and Rule 10b-5. The effect of the *Birnbaum* rule (and the basis for a degree of criticism in the commentaries) is that a person owning a security who elects not to sell on the basis of, for example, a fraudulently optimistic press release, lacks standing to bring an action in the absence of a jurisdictional purchase or sale based on the misstatement or omission.

It was not until the 1970s that the Supreme Court had occasion to affirm the lower courts’ finding of an implied civil liability under Rule 10b-5\(^{73}\) and also to affirm the *Birnbaum* rule.\(^{74}\) In *Blue Chip Stamps v. Manor Drug Stores*, as the result of an antitrust enforcement action, Blue Chip Stamps was required to reorganize itself and offer a substantial number of new shares of stock to retailers that had used Blue Chip trading stamps in the 1960s. The new stock offering was a 1933 Act registered offering, but Manor Drug Stores, one of the required offerees under the antitrust consent decree, decided not to purchase the stock, allegedly on the basis of unduly pessimistic statements in the prospectus. When the price of the stock subsequently increased in value,

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72. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). The fraudulent conduct referred to in Rule 10b-5 is “in connection with the purchase or sale of any security.”
Manor Drug Stores complained that Blue Chip Stamps prepared a misleading prospectus to discourage Manor Drug Stores from purchasing shares at the low price established in the consent decree, thereby permitting Blue Chip Stamps to sell the stock in a public offering at a substantially higher price. The Supreme Court affirmed the Birnbaum rule that Manor Drug Stores lacked standing because it neither purchased nor sold securities of Blue Chip Stamps.

It is in the concurring opinion of Justice Powell that Blue Chip Stamps v. Manor Drug Stores emphasizes the language of section 10(b) and Rule 10b-5, comparing it to the language of other provisions of the securities laws. The 1933 and 1934 Acts clearly distinguish between “offers” and purchases or sales. Section 17(a) of the 1933 Act, for example, expressly includes offers within the scope of its antifraud language. The majority opinion of Justice Rehnquist places more emphasis on the policy reasons supporting the Birnbaum rule, including its overwhelming acceptance by the lower courts during the twenty-five years before the issue reached the Supreme Court. The primary policy issue supporting the Birnbaum rule, according to the majority opinion, is the likelihood of strike suits against companies whenever a fact pattern could be found in which nonpurchasers could claim a decision not to invest was based on material misstatements or omissions. Damages would be difficult to calculate and causation highly problematic, but the very existence of the strike suit would give it “settlement value,” forcing companies into negotiations with opportunistic plaintiffs who never risked capital by a purchase or sale of defendants’ securities.

The Supreme Court recognized that the effect of its holding in Blue Chip Stamps was that three principal categories of plaintiffs would be excluded from standing:

• potential purchasers of securities who claim they decided not to purchase the securities because of “unduly gloomy representation or the omission of favorable material”;[76]

75. In the same year that the Supreme Court decided Blue Chip Stamps, Congress enacted the 1975 Amendments to the 1934 Act, including the addition of language in § 15(c)[2] making it unlawful for any municipal securities dealer “to induce or attempt to induce the purchase or sale of any security in connection with which such municipal securities dealer engages in any fraudulent . . . act or practice. . . .” This language clearly gives the SEC enforcement powers for conduct that could not be reached under Rule 10b-5.

76. Blue Chip Stamps, 421 U.S. at 737.
• existing holders of an issuer’s securities who claim they decided not to sell their securities because of “unduly rosy representation or the failure to disclose unfavorable information”;77 and  
• “security holders, creditors and perhaps others related to an issuer who suffered a loss in value of their investment due to corporate or insider activities,” in connection with their improper purchase or sale of securities.78

The Birnbaum court founded its purchaser-seller rule in the language of section 10(b), namely the phrase “in connection with the purchase or sale of any security,” and the concurring opinion of Justice Powell in Blue Chip Stamps focuses on the statutory language, but the majority opinion of Justice Rehnquist, after discussing the language and efforts by the SEC to amend the language after Birnbaum to include “offers to sell,” is based primarily on policy considerations.79

The opinion speaks at length on problems of vexatious litigation if the remedy of section 10(b), which is implied to begin with, is not implicitly confined to purchasers and sellers. This reading of Blue Chip Stamps allowed Justice Stevens, in Dabit,80 to use a similar policy

77. Id. at 737–38.
78. Id. at 738.
79. The shift in reasoning begins with the following oft-cited statement of Justice Rehnquist:

Having said all this, we would by no means be understood as suggesting that we are able to divine from the language of section 10(b) the express intent of Congress as to the contours of a private cause of action under Rule 10b-5. When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it... but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider, in addition to the factors already discussed what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

421 U.S. at 737.

80. Merrill Lynch, Pierce, Fenner & Smith, Inc., v. Dabit, 547 U.S. 71, 84 (2006). Justice Stevens cited United States v. Naftalin, 441 U.S. 768, 774, n.6 (1979) and the Second Circuit opinion below, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 395 F.3d 25, 39 (2d Cir. 2005), which acknowledged that “[t]he limitation on standing to bring [a] private suit for damages for fraud in connection with the purchase or sale of securities is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities.”
argument to construe the language of the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which provides for federal preemption of certain class actions “in connection with the purchase or sale of a covered security” to preempt cases in which the class is defined by persons who neither purchase nor sell, but simply hold securities. The combined effect of Dabit, which is discussed in section 8:1.1[B], and Blue Chip Stamps is that SLUSA preempts certain class actions by mere holders of securities, preventing holders from bringing vexatious litigation in state court and thus leaving them without a remedy, since they would lack standing in federal court.

The important aspect of Justice Stevens’s reasoning in Dabit is that he clarifies that the phrase “in connection with” is not to be limited by the purchaser-seller requirement of the Birnbaum rule. The purchaser-seller limitation determines standing, but it does not act as a limitation on the phrase “in connection with the purchase or sale of any security.” Justice Stevens concludes: “The requisite showing, in other words, is ‘deception in connection with the purchase or sale of any security,’ not deception of an identifiable purchaser or seller.”

It is well known among practicing lawyers that overly pessimistic statements can be as misleading as statements that are overly optimistic. However, one of the effects of the Birnbaum rule is that the drafters of disclosure documents in a new issue distribution are less concerned about pessimistic statements that result in a decision not to invest. Lawyers can be extremely cautious in the drafting of sections such as “risk factors,” knowing that there is no threat of an action by noninvestors. The negative imbalance of many disclosure documents reflects a perception that optimistic misstatements that result in a purchase of a distribution of securities are potentially more dangerous than pessimistic misstatements that do not result in a purchase.

The Supreme Court revisited Blue Chip Stamps in its 2001 unanimous decision that the “in connection with” requirement was met in the circumstances described in Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc. The case arose from a decision by Wharf to bid for an exclusive license to operate cable television in Hong Kong. Wharf orally

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granted United an option to buy 10% of the future system’s stock. The cable franchise was awarded to Wharf, but Wharf refused to permit United to exercise its option, and apparently never intended to fulfill the oral agreement. United brought a securities fraud action under Rule 10b-5, was awarded compensatory damages by the jury, and the award was upheld by the Tenth Circuit Court of Appeals. The Supreme Court granted certiorari to determine whether Wharf’s oral sale of an option it intended not to honor was prohibited by Rule 10b-5. Based on the pleadings, Justice Breyer treated the “security” at issue as the option and not the underlying cable system stock. Wharf argued that Rule 10b-5 does not cover oral contracts and that, since the transaction was not completed, United was not a purchaser under the “in connection with” requirement of Blue Chip Stamps. Wharf characterized the case as a contract law dispute over the ownership of stock and not a securities fraud and therefore outside the jurisdiction of the securities laws.

The Court held that the 1934 Act covers oral contracts, stating that section 10(b) refers to “any contract” for the purchase or sale of a security and citing Article 8 of the U.C.C.83 Justice Breyer distinguished Blue Chip Stamps by reasoning that it was concerned with a potential buyer who did not actually buy the securities but might have done so had the seller told the truth. United was not a potential buyer, but, by providing Wharf with services, it actually bought the option that Wharf sold. There was no doubt that United intended to exercise its option, and therefore the policy concern of Blue Chip Stamps was not at issue. In the oral argument before the Supreme Court, Justice Scalia stated that the Blue Chip Stamps factual problem for the courts was “whether the plaintiff would have bought the stock or not. You have no idea whether the plaintiff [in Blue Chip Stamps] would have bought this stock [but for the misrepresentation].” Justice Scalia went on to describe Blue Chip Stamps as: “Oh had I known this, I would have. Had I not known it, I would not have. And it’s all speculation about the future. There’s no speculation about the future here [in Wharf].”84

83. U.C.C. Art. 8, § 113: “a contract . . . for the sale or purchase of a security is enforceable whether or not there is a writing signed . . . by a party against whom enforcement is sought.”

[B] Municipal Bond Insurers As Purchasers or Sellers: The FSA and MBIA Cases

Bond insurance is a financial guaranty insurance policy that acts as a guaranty of the payment of principal and interest on debt securities
in the event of an issuer payment default. The insurance is non-cancellable and unconditional. Upon notice of a payment default, the bond insurer makes payment to a commercial bank acting as fiscal agent, and the fiscal agent disburses the amount due and payable, on the originally scheduled principal and interest payment dates, to the holders of the securities. Upon the payment by the insurer, the insurer becomes the owner of the insured securities and is subrogated to all of the security holders’ rights under the securities. The security holders collect principal and interest from the fiscal agent in accordance with the scheduled maturity, or mandatory sinking fund installment date, and interest payment dates set forth in the security, and the right to payment of principal and interest from the issuer then vests in the bond insurer.

The question is whether the financial guaranty insurer is a purchaser of the bonds it insures in order to determine standing as a plaintiff in a securities fraud case brought under section 10(b) and Rule 10b-5. The Eleventh Circuit held in 2007 that Financial Security Assurance, Inc. (FSA) was not a purchaser, and the district court for the Southern District of New York held in 2004 that MBIA Insurance Corporation was not a purchaser. Financial Security Assurance, Inc. v. Stephens involved bonds issued by a solid waste authority in Georgia to finance a solid waste processing facility to remove recyclable material from solid waste before dumping the remainder into a landfill. The bonds were secured by “put or pay” participant agreements with more than thirty municipalities and private companies, tipping fees paid by the waste haulers, and revenues from the sale of recyclables. FSA was the bond insurer. Within two months of the closing, the issuer notified FSA that it was forced to revise its budget and cash flow analysis. Contracts were amended to provide incentives to the waste hauler, but reducing revenues. After exhausting the debt service reserve fund, the issuer defaulted, and FSA was required to make payments under its bond insurance policy.

FSA brought a section 10(b) action and an action under state law for common law fraud and negligent misrepresentation against Stephens, Inc., the underwriter, and Hayes, James & Associates, Inc., the feasibility consultant. FSA argued it had standing as a purchaser or seller under Rule 10b-5 on four independent grounds: (1) as the true party at risk in the transaction, (2) as the seller of the guaranty, which is a security, (3) as the purchaser of the bonds after default pursuant to

85. Fin. Sec. Assurance, Inc. v. Stephens, Inc., 500 F.3d 1276 (11th Cir. 2007), reversing on rehearing 450 F.3d 1257 (11th Cir. 2006).
the terms of the insurance policy, and (4) as subrogee, that is, subrogated to the rights of the holders of the securities upon payment under the insurance policy. The court rejected all four arguments.

The “true party at risk” argument was denied because the court reasoned that the Supreme Court in *Blue Chip Stamps* treated the Birnbaum rule as a formal, bright-line test that does not invite a factual inquiry into circumstances in which a transaction functions like a purchase. The court dismissed FSA’s argument that it was the seller of a security, the guaranty, as a “novel theory” because a guaranty “does not qualify as a security for Rule 10b-5 purposes.” The argument was not novel when it is recognized that a guaranty is clearly a security under the 1933 Act, as described at length in chapter 2. However, the definition of a security under section 3(a)(10) of the 1934 Act is not the same as the definition of a security under section 2(a)(1) of the 1933 Act because the 1934 Act definition does not include the phrase “or any . . . guarantee of . . . any of the foregoing,” which are the operative words for concluding that corporate and financial guarantees are securities under the 1933 Act.

FSA’s third claim was that the terms of the bond insurance policy made FSA a purchaser under the policy’s clause that “[u]pon disbursement in respect of a Bond, [FSA] shall become the owner of the Bond.” FSA argued that the definition of a purchase under section 3(a)(13) of the 1934 Act includes “any contract to buy, purchase, or otherwise acquire” securities, and the clause in the policy is a “contract to . . . acquire” a security. The court rejected the claim, not because there was no purchase, but because what was purchased was not a security. “Although by the insurance policy’s own terms FSA acquired the bonds upon default by the Authority, we conclude that at the time of such transfer the instruments FSA acquired were no longer ‘securities’ as required for standing under Rule 10b-5.” In support of this statement, the court reviewed three Supreme Court decisions defining a security as an “investment contract” (an investment of money in a common enterprise), “stock” (the right to receive dividends), and a “note” (buyer is interested in profit).

The Eleventh Circuit failed to consider whether the bonds acquired by FSA after a payment default were an “evidence of indebtedness,”

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87. Ironically, the court did not mention *SEC v. Edwards*, 540 U.S. 389 (2004), in which the Supreme Court reversed the Eleventh Circuit itself in the 2004 Supreme Court’s opinion on the definition of a security. The Supreme Court held that the Eleventh Circuit erred in holding that investment contracts with a “fixed return” were not securities, but the Eleventh Circuit in *FSA v. Stephens* did not consider the possibility that FSA acquired a security under the Superior Court’s definition in *SEC v. Edwards*.
which is an instrument “commonly known as a security.” When there is a default, a bond insurer makes payment of principal, sinking fund installments, and interest in accordance with the scheduled terms, and the bond insurer receives the bonds in order to be reimbursed from the issuer in accordance with the terms of the bonds. Because the issuer is in payment default, ordinarily the issuer and the bond insurer will enter into a workout agreement based on the ability of the issuer to reimburse the bond insurer, who is entitled to payments of principal, sinking fund installments, and interest on the bonds. In negotiating the workout agreement, the bonds owned by the bond insurer are the evidence of indebtedness of the issuer and a fixed obligation of principal and interest. Rather than concentrating on the bond insurance policy, the court cited the official statement as authority for the conclusion that the bond insurer had no right to receive principal and interest on the bonds, because after bonds have been “redeemed, the owners of such bonds or portions thereof ceased to be entitled to any benefit or security under the Bond Resolution.” The opinion then quotes the redemption language of the official statement to the effect that when bonds have been redeemed, holders will no longer have any rights under the bonds. After quoting the redemption language at length, the court concluded that FSA “had no right to past payment of principal and interest because the obligation to pay those portions of the bond had been discharged by FSA’s disbursement of the amount that was due for payment.” Redemption provisions are irrelevant to payments of bond insurance on default or the issuer’s obligation to pay the bond insurer. What the court seems to be trying to say is that when the bonds are owned by FSA, they cease to have the investment characteristics of a security, regardless of their implications for a workout agreement.

FSA’s fourth argument was that it had standing based on its rights of subrogation to the holders of the bonds. The court defined subrogation as “[t]he substitution of one person in the place of another with reference to a lawful claim, demand or right, so that he who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights, remedies or securities.” The court concluded

88. The definition of a security in section 2(a)(1) of the 1933 Act includes an “evidence of indebtedness.” The definition of a security in section 3(a)(10) of the 1934 Act does not list an evidence of indebtedness, but does include “any instrument commonly known as a security.” The fact that an evidence of indebtedness is listed in the 1933 Act definition suggests that it is an instrument commonly known as a security. The Supreme Court in SEC v. Edwards, 540 U.S. 389 (2004) stated “Section 2(a)(1) of the 1933 Act . . . and section 3(a)(10) of the 1934 Act . . . , in slightly different formulation which we have treated as essentially identical in meaning.”
that the original bondholders would have had standing to bring a claim under Rule 10b-5 as the “actual purchasers of the bonds,” but FSA failed to allege harm to the bondholders caused by misrepresentations of the defendants, and instead FSA claimed that it was deceived. “As a subrogee, FSA cannot file a complaint based on harm to itself.”

There are portions of the opinion in Financial Security Assurance, Inc. v. Stephens that are strained in their reasoning, which suggests that there were policy reasons that led the court to conclude FSA was not a purchaser or seller for standing under Rule 10b-5. The underlying policy issues were brought to the surface in MBIA Insurance Corp. v. Spiegel Holdings, Inc., a case involving asset-backed notes for credit card receivables on a private label credit card used for customer purchases from the Spiegel catalogue. MBIA issued a financial guaranty policy insuring payment of the asset-backed notes. Spiegel, Inc., the parent of the companies involved in the securitization, filed for bankruptcy, and MBIA filed separate actions against Spiegel Holdings, Inc., the owner of Spiegel, Inc., for breach of contract and, on behalf of the noteholders, for securities law fraud under various provisions of the securities laws, including Rule 10b-5.89

The district court rejected MBIA’s argument that it was acting as a surrogate plaintiff on behalf of the noteholders, who were purchasers, by concluding MBIA was not comparable to a trustee under a trust indenture, who is allowed to act as a representative of security holders.90 The court then rejected MBIA’s claim that it should be treated as a de facto purchaser or seller for the reason that Blue Chip Stamps foreclosed an “endless case-by-case erosion” of the purchaser or seller requirement. The court was also unsympathetic to MBIA’s argument that if the bond insurer cannot bring a fraud action, no one will be able to bring an action because the security holders will have been paid by the bond insurer and would not be able to allege damages by loss causation. Blue Chip Stamps, the court reasoned, had recognized the potential gaps in remedial relief, but decided a literal reading of Rule 10b-5 was necessary.

The court concluded with the policy argument that MBIA is in the business of providing a commercial product with associated risks, and is compensated for those risks by premium payments. It is not an investor with the remedies of an investor:

89. The asset-backed notes were registered with the SEC under the 1933 Act, and the action by MBIA was brought under sections 11 and 12(a)(2) of the 1933 Act, as well as Rule 10b-5. Sections 11 and 12(a)(2) are express remedies available to purchasers of the relevant securities.

MBIA’s claims ring hollow in the context of a sophisticated commercial insurer who is in the business of providing “financial guaranty insurance to the issuers of asset-backed securitizations” . . . MBIA is an insurer—it evaluates risk and charges premiums accordingly. Occasionally, it may find itself in the position of having to make disbursements on policies, precisely because of the occurrence of events whose contemplation prompted people to seek insurance in the first place.

The policy argument against bond insurers being given the status of a purchaser or seller under Rule 10b-5 was amplified by the Bond Market Association (TBMA), a predecessor organization to the Securities Industry Financial Markets Association (SIFMA), in an amicus curiae brief filed with the Eleventh Circuit in connection with Financial Security Assurance, Inc. v. Stephens:

Considerations of public policy also strongly weigh against any weakening of Blue Chip Stamps’ purchaser/seller requirement in this case. The Panel’s decision threatens the established workings of the insured bond market, including the independent review of each insured bond offering currently performed by insurers. Purchasers of bonds look to financial guaranty insurance not only as guaranty of repayment but also as an independent statement by the guarantor that the bond issue has a low risk of default . . . . Expanding the reach of the federal securities laws to allow monoline insurers to assert a Rule 10b-5 claim would undercut the value of financial guaranty insurance by providing a disincentive to insurers to continue performing the type of independent analysis expected by the rating agencies, by state insurance regulators and by the market place. 91

[C] Indenture Trustee’s Capacity to Act for Purchasers and Sellers of Municipal Bonds

Section 10(b) and Rule 10b-5 require that a plaintiff asserting standing to bring a federal securities claim must be either a purchaser or a seller of the securities. The question then arises whether the trustee acting under a trust indenture has the capacity to represent plaintiffs who purchased or sold when the trustee itself was neither a purchaser nor a seller. In class action litigation, such as the $2.25 billion default of the Washington Public Power Supply System (WPPSS), the issue is likely to arise earlier in the proceedings as a
motion to dismiss by defendants challenging the trustee’s capacity and later by one or more classes of plaintiffs dissatisfied with settlement allocations agreed to by the trustee.

In the 1985 motion to dismiss, the WPPSS court distinguished *Blue Chip Stamps v. Manor Drug Stores*. There the Court held that a Rule 10b-5 action required the plaintiff to be either a purchaser or a seller of the securities that were affected by fraudulent misstatements or omissions. The Supreme Court did not have before it the question of a person’s ability to act in a representative capacity for actual purchasers or sellers. The WPPSS district court in both the 1985 motion to dismiss and the 1989 settlement proceedings established the trustee’s capacity to act as a representative of bondholders in federal securities law actions by reference to the bond resolution adopted by WPPSS. The purchaser-seller requirement must be satisfied by the bondholders, not the trustee.

A trust indenture or a bond resolution is a contract between the issuer and the bondholders. Throughout the document there are covenants of the issuer. The remedies sections typically follow the detailing of events of default, and the trustee’s authority to act on behalf of the bondholders is set forth in one or more of the remedies sections. Since the trust indenture or bond resolution is a series of covenants, the primary remedial duty of the trustee will be in the enforcement of the covenants contained in the document. The trustee is therefore, in most cases, specifically authorized to enforce the rights of the bondholders under the trust indenture or bond resolution. For the trustee to have clear authority to bring a mandamus action, seek an injunction or represent bondholders in tort or fraud claims, there will likely be language in addition to the right to enforce the trust indenture or the bond resolution. In the WPPSS litigation, the district court found such authority in bond resolution language providing that

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95. The remedies may be drafted into the statute creating or empowering the issuer, or other state law, rather than drafted into the trust indenture or bond resolution.

96. The statute creating or empowering the issuer may have a legislatively mandated remedial system that, for example, utilizes government officials as representatives of bondholders rather than the trustee.
the trustee was entitled to enforce “any other legal or equitable right” for the benefit of the bondholders.\footnote{In re Wash. Pub. Power Supply Sys. Sec. Litig., 623 F. Supp. 1466, 1483 (D.C. Wash. 1985); \textit{Id.}, 720 F. Supp. 1379, 1421–23 (D. Ariz. 1989).}

The issue for dissatisfied classes of plaintiffs in the representation of the trustee is more complicated than it is for defendants in a motion to dismiss. Bondholders who concede courtroom representation to the trustee may resist loss of control of the proceedings. The Supreme Court spoke emphatically to this issue in \textit{Kersh Lake Drainage Dist.}:

\begin{quote}
It has been held that bondholders are not necessary parties to and are bound by the decree—even if adverse to their interests—in litigation wherein an indenture trustee under a bond issue is a party and exercises in good faith and without neglect his contractual authority to represent and assert the lien securing the issue.\footnote{Kersh Lake Drainage Dist. v. Johnson, 309 U.S. 485, 491 (1940)}
\end{quote}

To protect the bondholders, the courts will examine both the authority of the trustee and the adequacy of the representation. The latter issue speaks to limits on the reach of representative litigation and is addressed in the \textit{Restatement (Second) of Judgments}.\footnote{The general rule that a represented person may be bound is stated in \textit{RESTATEMENT (SECOND) OF JUDGMENTS} § 41 (1982). The exceptions are in § 42(1):
\begin{quote}
A person is not bound by a judgment for or against a party who purports to represent him if:
\begin{enumerate}[\textbf{(}a\textbf{)}]
\item Notice concerning the representation was required to be given to the represented person, or others who might act to protect his interest, and there was no substantial compliance with the requirement; or
\item The subject matter of the action was not within the interests of the represented person that the party is responsible for protecting; or
\item Before rendition of the judgment the party was divested of representative authority with respect to the matters as to which the judgment is subsequently invoked; or
\item With respect to the representative of a class, there was such a substantial divergence of interest between him and the members of the class, or a group within the class, that he could not fairly represent them with respect to the matters as to which the judgment is subsequently invoked; or
\item The representative failed to prosecute or defend the action with due diligence and reasonable prudence, and the opposing party was on notice of acts making that failure apparent.
\end{enumerate}
\end{quote}}

In the 1989 settlement proceedings, the WPPSS court found authority on the basis of the bond resolution as described above and determined
that the representation by the trustee was fully adequate under the standards of the restatement. 100

§ 8:3.2 The Range of Potential Defendants

[A] “In Connection with” As a Determining Factor

Section 10(b) and Rule 10b-5 make unlawful fraudulent conduct “in connection with the purchase or sale of any security,” a phrase that incorporates three jurisdictional requirements: (1) a security is involved, (2) there is a purchase or sale of a security, and (3) there is a connection of the fraudulent conduct with the purchase or sale of a security. The “in connection with” requirement is jurisdictional because, even though there may be a security involved, the alleged fraudulent conduct may not have occurred in a securities transaction. The misconduct may be common law fraud, and a securities transfer may be lurking on the periphery, but if the fraud is not connected with the securities transaction, Rule 10b-5 does not come into play.

The phrase was first considered in *Texas Gulf Sulphur* 101 in the context of statements made by the issuer at a time when the issuer was not purchasing or selling. A press release was considered misleading because it downplayed the importance of a drilling strike. If the Second Circuit had held that the defendant must be trading at the time of the statement, Rule 10b-5 would not reach continuing disclosure in the post-distribution period. Instead, the court concluded that the “in connection with” requirement was satisfied “whenever assertions are made . . . in a manner reasonably calculated to influence the investing public.” 102 The purchase or sale requirement must be satisfied by the plaintiffs under the Birnbaum rule described in the preceding section, but it is not necessary that the defendant and the plaintiffs both be contemporaneously purchasing or selling. There must, however, be a legal nexus between the acts of the defendant and the purchasing or selling by the plaintiffs, referred to by the phrase “calculated to influence.”

The meaning of “in connection with,” and the reach of its net for potential defendants, was the subject of three Supreme Court decisions between 1997 and 2002: *United States v. O’Hagan*, 103 *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*, 104 and SEC v.

102. *Id.* at 860. See also Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (construing the requirement liberally to include practices “touching” the purchase or sale of securities).
Before summarizing the thrust of those decisions, it is useful to describe the different ways the “in connection with” requirement has been understood. In 1984, the Second Circuit decision in *Chemical Bank v. Arthur Anderson & Co.* considered a commercial bank loan to a private company that was collateralized by a pledge of securities. Under the securities laws, a pledge of securities is considered a sale of securities. A pledge of securities thus satisfied the section 10(b) requirement of a purchase or sale of securities. The bank claimed it entered into the loan in reliance on the borrower’s financial statements, certified by the defendant accounting firm, and that there were fraudulent misstatements in the financials. The bank brought an antifraud action under section 10(b), and the district court denied Andersen’s motion to dismiss for lack of jurisdiction, holding that the alleged fraud was in connection with the sale of securities pledged as collateral. The Second Circuit agreed that the pledge of stock was a sale of securities, but reversed because it found no connection between the fraud and the pledge, stating that “[i]t would be anomalous to hold that commercial bank loans procured by fraud are generally not within . . . Rule 10b-5, but that they become so, . . . if collateralized with a security, although no misrepresentation was made with respect to the latter.”

This statement was interpreted by some commentators to imply that the misrepresentation must be about the value of the securities that give rise to jurisdiction. Thus, a year later, a district court within the Second Circuit was confronted with a case involving repurchase agreements (repos) entered into by a government securities dealer. The SEC alleged the financial statements of the dealer concealed a severe deficit in the firm’s capital that could affect the ability of the firm to repurchase the government securities that were the subject of the repo. A repo is a contract (like a swap agreement) and not itself a security. The district court read *Chemical Bank* to require a dismissal, because there was no misrepresentation about the value of the underlying government securities. The Second Circuit reversed, and distinguished *Chemical Bank*, holding that, in a repo transaction, the firm’s ability to repurchase the government securities was dependent on its capital, and, therefore, there was a direct link between the fraud and the securities transaction.

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107. Id. at 944.
Two divergent ways of thinking about the “in connection with” requirement are apparent in these cases. One approach is to construe the test stringently to require that the fraud be about the security that is the jurisdictional subject security for purposes of Rule 10b-5. The Second Circuit backed away from this reading of Chemical Bank in the Drysdale repo case by finding that there was a link between the misrepresentation about the financial health of the government securities dealer and the transfer of the government securities: “[Drysdale’s] financial strength was essential to the value received by the other party in a securities transaction.”\(^{110}\) In Drysdale there is a tight connection, but once the connection of the fraud is separated from statements about the securities, the requisite connection is likely to vary considerably among courts. An investment banker influences a city council to vote for a bond issue by making payoffs to a city official to misrepresent the urgency of the financing to other members of the city council. The bonds are accurately described in the official statement, are for a valid purpose, are fully secured, and never default. Can the SEC bring an enforcement action against the underwriter for fraud in connection with the sale of securities? The nexus between the fraud and the securities is not nearly as tight as in the Second Circuit’s Drysdale decision, but courts are likely to allow the SEC action.\(^{111}\)

An important, usually unstated, factor in affecting the tightness of the required connection is the subpart of Rule 10b-5 that is at issue. The most frequently cited is Rule 10b-5(b), which makes unlawful any misstatements or omissions of a material fact, and these misleading statements are likely to be closely connected to the actual security purchased or sold. On the other hand, Rule 10b-5(a) and (c) relate to “schemes” to defraud or courses of “business conduct” that have the effect of a fraud or deceit. These illegal activities are more likely to relate to the setting in which the purchase or sale takes place. The connection of the scheme or business conduct with the security is likely to be less immediate. In these situations, there may well be untrue statements, but they may be designed to encourage the victim to be taken in by the scheme that leads to the purchase or sale. Each of the three Supreme Court cases between 1997 and 2002 illustrated the effect of a scheme or business conduct situation for purposes of the “in connection with” analysis.

In United States v. O’Hagan, the defendant was a law firm partner who accessed information within the firm that a firm client was about to make a tender offer for a target company. The partner began purchasing shares and options in the target company. The Supreme

\(^{110}\) Drysdale Sec. Corp., 785 F.2d at 42.

\(^{111}\) See Black, supra note 109.
Court held that the defendant committed fraud “in connection with” a securities transaction when he used misappropriated confidential information for trading purposes. The fraud was consummated not when the partner, a fiduciary, gained the confidential information, but when, without disclosure to the client, he used the information to purchase or sell the securities. The fraudulent breach of duty to the client was connected with the securities transaction, even though the primary person defrauded was not the other party to the trade, but, instead, the client source of the nonpublic information.\textsuperscript{112}

The facts in \textit{Wharf} are described above in the section on the Birnbaum rule because the case discusses the purchaser-seller requirement, as well as the “in connection with” nexus. The case involved the intent of the seller of an option. The defendant, owner of Wharf, orally sold the plaintiff an option in Wharf stock as payment for services to Wharf, while secretly intending from the beginning of their business relationship not to honor the option. The defendant argued that the case was a commercial contract law case, and jurisdictionally the contract dispute was not connected with a purchase or sale of a security. The Supreme Court rejected the argument because the purchaser’s claim was not that the defendant failed to carry out a promise to sell securities; rather, the claim was that the defendant sold a security while never intending to honor the agreement in the first place. The fraudulent intent deprived the plaintiff of the benefit of the sale of the option.\textsuperscript{113} The SEC had filed an amicus curiae brief in \textit{Wharf} in which it interpreted the \textit{O’Hagan} opinion on the meaning of “in connection with” to the effect that “a misrepresentation is made ‘in connection with the purchase or sale of any security’ when the misrepresentation and the securities transaction are part of the same fraudulent scheme.”\textsuperscript{114} Scheme liability was subsequently a major theme of Rule 10b-5 litigation under Rule 10b-5(a) and (c).

The SEC’s language, “part of the same fraudulent scheme,” is significant in public finance cases involving market integrity where, for example, a market participant bribes an official of an issuer to vote for the issuance of securities, and the issuer subsequently sells the securities. The “connection” between the misconduct and the “purchase or sale” is made because there is a single overall fraudulent scheme. However, in \textit{United States v. O’Hagan}, Justice Ginsburg provided an illustration of a severed connection citing circumstances in which a person defrauds a bank into giving a loan or embezzles cash from another and then uses proceeds of the misdeed to purchase

\begin{itemize}
  \item \textsuperscript{114} Brief of Amicus Curiae SEC, \textit{Wharf (Holdings) Ltd.}
\end{itemize}
securities. In that situation “the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained.” 115

The Fourth Circuit used Justice Ginsburg’s illustration to conclude that the “in connection with” requirement was not met in a case in which a broker persuaded an elderly man to open a discretionary investment account for himself and his mentally retarded daughter. 116 The broker sold the customer’s securities and used the proceeds for his own benefit without the customer’s knowledge or consent. Approximately $343,000 was transferred to an account controlled by the broker. When the customer died, it was discovered that all the money he had entrusted to the broker was gone. The broker was convicted of wire fraud, and the SEC filed a civil complaint. The district court entered a summary judgment against the broker on a motion arguing the “in connection with” requirement was not met. The Fourth Circuit reversed, finding that the sales of the customer’s securities were conducted in “a routine and customary fashion” and that the fraud was in the separate act of “absconding with the proceeds.” 117

On certiorari the Supreme Court reversed. 118 Writing for a unanimous Court, Justice Stevens summarized the case as follows:

The SEC claims respondent engaged in a fraudulent scheme in which he made sales of his customer’s securities for his own benefit. Respondent submits that the sales themselves were perfectly lawful and that the subsequent misappropriation of the proceeds, though fraudulent, is not properly viewed as having the requisite connection with the sales; in his view, the alleged scheme is not materially different from a simple theft of cash or securities in an investment account. We disagree. 119

Justice Stevens found that the Fourth Circuit read Justice Ginsburg’s illustration in O’Hagan to require that the misappropriated information or assets not have independent value outside the securities market. Regardless of the correctness of this reasoning, Justice Stevens on the Zandford facts concluded that the customer’s securities in the discretionary account did not have value for the broker “apart from their use in a securities transaction and the fraud was not complete before the sale of securities occurred.” 120 The test for determining whether the “in connection with” requirement has been met that emerges from O’Hagan and Zandford is that the requirement

115. 521 U.S. 642, 656.
117. Id. at 564.
118. Id. at 564.
120. Id. at 1899.
is satisfied whenever a fraudulent scheme “coincides” with securities transactions, regardless of the subject matter of any actual misrepresentations or misleading omissions contributing to the fraudulent scheme.\footnote{121} Four months before the Supreme Court’s decision in \textit{Zandford}, the SEC announced a cease-and-desist order in an administrative proceeding against Pryor, Counts & Co., Inc. (formerly Pryor, McClendon, Counts & Co., Inc.) (PMC) concerning PMC’s handling of the city of Atlanta’s portfolio of U.S. zero-coupon securities (STRIPS) and a series of concealed payments and political contributions to public officials and candidates for office in New York and Atlanta.\footnote{122} The SEC found that an Atlanta investment officer secretly set aside for PMC $9.8 billion in purchase and sales of STRIPS, representing virtually all the city’s STRIPS business at a time when PMC was providing monetary benefits to the official and her husband. Payments for the benefit of the husband included providing capital through a conduit for the husband’s new business activities. The SEC found that the payments were not disclosed to the city. PMC employed the same conduit used to funnel money to the husband to make payments to another city official during the period PMC was seeking and obtaining underwriting business from Atlanta. There was no evidence this official actually influenced the selection of underwriters by the city. In addition, the SEC found that PMC used the same conduit to make campaign contributions to an official of New York City in violation of MSRB Rule G-37 at a time PMC was seeking appointment as one of the underwriters for New York City.\footnote{123} Finally, the SEC found that PMC failed to keep accurate books and records by funneling contributions to the campaign of candidates for office in New York state and recording the payments as “consulting expenses” and “house repairs.”

In a cease-and-desist order, the SEC writes the opinion and discusses the reasoning behind its legal conclusions to the extent it determines appropriate in the context of the order.\footnote{124} With \textit{Zandford} pending before the Supreme Court, the SEC’s discussion of the “in connection with” limitation was perhaps intentionally abbreviated.

\footnote{121}{See O’Hagan, 521 U.S. at 656; SEC v. Zandford, 122 S. Ct. 1899, 1903–06 (2002).}
\footnote{123}{MSRB Rule G-37 limits the ability of brokers, dealers and municipal securities dealers to engage in municipal securities business with issuers whose officials have been given campaign contributions by the firm or municipal finance professionals. The rule is described in chapter 9.}
\footnote{124}{See discussion of cease-and-desist orders in section 13:3.}
On the payments related to Atlanta’s STRIPS program, the SEC simply concluded that PMC participated in a scheme to defraud the city of Atlanta in connection with the city’s purchase and sale of STRIPS securities. On the payments to the Atlanta official (after finding there was no evidence the official actually influenced the selection of underwriters), the SEC found a violation of MSRB Rule G-17\(^\text{125}\) on fair dealing, but, without comment, did not make a finding pursuant to Rule 10b-5 with its “in connection with” limitation. On the New York City facts, the SEC found a violation of Rule 10b-5 because in the interviewing process underwriters were specifically asked to make representations addressing conflicts of interest. PMC made written representations in its proposal that the SEC found misleading for failure to disclose the campaign contribution that violated MSRB Rule G-37. The SEC found violations of securities law record-keeping requirements with respect to the concealed campaign contributions for New York state officials, but did not find antifraud violations, again without comment.

The Supreme Court’s subsequent decision in Zandford, which is consistent with the SEC’s amicus position described above, allows a basis for conjecture on the SEC’s analysis of the “in connection with” requirement on the PMC facts and similar market integrity cases. Justice Ginsburg’s illustration in O’Hagan describing facts in which the unlawful obtaining of money has value apart from the subsequent investment of the money is not applicable to a market integrity case in which the fraud and the purchase or sale of securities are part of the same plan. The SEC’s findings suggest that PMC and the Atlanta investment officer concealed information from the city about the STRIPS program in order for PMC to purchase and sell the STRIPS on an exclusive basis. Justice Ginsburg’s hypothetical person who fraudulently obtains a bank loan may or may not be intending to invest the proceeds in securities, but the fraudulent obtaining of money has value to the wrongdoer without the necessity of the later investment. PMC’s failure to disclose conflicts of interests to New York City’s official in its written presentation for underwriting business was in order to obtain the underwriting business.\(^\text{126}\)

\(^{125}\) MSRB Rule G-17 requires brokers, dealers and municipal securities dealers to deal fairly with all persons. The rule is described in chapter 9.

\(^{126}\) The payment to an Atlanta official during the selection process for underwriters may have been part of a plan to obtain underwriting business, but without evidence the official was involved in the selection of underwriters, it would be difficult to make the connection. The SEC made no factual findings that the contributions to New York state officials were connected to the purchase or sale of securities.
When the plaintiff asserts a theory of “scheme liability” to make the connection between fraudulent conduct and a securities transaction, the connection may not be as immediate as a straightforward material misstatement or omission in a prospectus or official statement. The connection between the participants in a scheme and the investors may have to flow through a primary actor who makes a material misstatement or misleading omission to the investors through a disclosure document, in an analyst meeting, or in a press conference. Traditional cases under Rule 10b-5 involve subpart (b) of the rule, which makes unlawful material misstatements or omissions that are misleading in the circumstances in which they are made. Subparts (a) and (c) of Rule 10b-5, which make unlawful deceptive devices and fraudulent business conduct, will often be communicated to investors through a person making a misleading statement in violation of subpart (b) unless the alleged conduct, like stock manipulation, speaks for itself. Likewise, scheme liability suggests that more than one person may be involved in the wrongdoing, and from the perspective of plaintiffs’ lawyers, the search for potential behind-the-scenes wrongdoers is likely to be motivated by the need to search for more than one wrongdoer to find deep pockets capable of paying damages.

The connection required between secondary actors and a disclosure in a securities transaction is a significant issue in public finance, given the various parties that may exist in a financing that is highly structured to achieve security. The issue litigated may not necessarily involve a scheme, but may simply represent an effort to determine the “background” people who should bear responsibility for the disclosures in the official statement. In the Washington Public Power Supply System securities litigation, the basic issue was the plaintiffs’ allegations that the official statements contained material misrepresentations. Among the defendants were eighty-eight public utilities that had signed participants’ agreements with WPPSS. Pursuant to those agreements, the participants each agreed to purchase a percentage of project capability of two nuclear power plants, projects 4 and 5.

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127. In a motion for summary judgment, In re Wash. Pub. Power Supply Sys. Sec. Litig. [MDL No. 551], order dated July 14, 1988, the defendants sought dismissal of several allegations of material misrepresentations in the official statements. The district court denied the motion, finding that the plaintiffs had provided sufficient evidence to take to the jury on the following allegations of official statement misrepresentation:

1. the ability of the participants to finance the costs of the projects,
2. the ability of the participants to pay bondholder obligations as they come due,
When the Washington Supreme Court held that certain of the municipal utilities lacked authority to enter into participant agreements, the security for outstanding bonds for projects 4 and 5 was undermined, and $2.25 billion of bonds went into default. The participants were not the issuer of the bonds, but the official statements necessarily included information about the participants.

Certain of the participants, who were nonmembers of WPPSS, filed a motion for summary judgment on the theory that information provided by them to WPPSS, the issuer, was not given in connection with the purchase or sale of the bonds by plaintiffs. The district court denied the participants’ motion, concluding that the connection between statements provided by the participants and plaintiffs’ purchases of bonds was sufficient for purposes of section 10(b) and Rule 10b-5. The court reasoned that the information provided by the participants “for inclusion in the official statements” could be inferred to have been “reasonably calculated to influence the investing public.”

The search for multiple defendants raises issues of proximity in the causal connection, reliance, and gradations of scienter. In 1994, the Supreme Court reined in the ability of plaintiffs to name secondary defendants in Central Bank v. First Interstate Bank by ruling that Rule 10b-5 did not provide an implied right of action against persons accused of aiding and abetting a securities fraud. The facts of the case are outlined in chapter 12, describing the potential liability of financial advisors. Central Bank involved a public building authority in Colorado Springs that issued two series of municipal bonds in 1986 and 1988 to finance public improvements for a planned residential and commercial development. The trust indenture required an annual coverage certificate to be filed with the trustee by the developer, and when doubts were expressed by the underwriter of the 1988 bonds about the validity of the real estate appraisals, which were necessary to show coverage of the 1986 bonds and the upcoming 1988 bonds, the trustee acceded to the request of the developer for a delay in obtaining

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130. Id. at 32–33. The motion for summary judgment also included other means for defining the scope of possible defendants: conspiracy, aiding and abetting, and controlling persons. Id. at 33–45.
an independent review of the appraisal until after the issuance of the 1988 bonds. The 1988 bonds were issued and went into default. Investors in the 1988 bonds brought a section 10(b) action against the authority, two underwriters, and the developer as primary violators, and against Central Bank, the trustee, charging the bank was secondarily liable for conduct in aiding and abetting the fraud. The Supreme Court found considerable doubt in the circuit courts about an implied cause of action for aiding and abetting, and granted certiorari.

Justice Kennedy wrote a lengthy review of section 10(b) cases in the Supreme Court, noting the Court’s propensity to look to express remedies in the securities laws for guidance about Congressional intent regarding implied remedies, and to the actual text of section 10(b). He found that where Congress drafted express remedies in the securities laws it usually did not include aiding and abetting liability, suggesting it would not have intended aiding and abetting to be judicially gleaned from an implied remedy. As to the text of section 10(b), Justice Kennedy reasoned that each of the elements of a cause of action was to be applied in considering the trustee’s liability, and he found that, generally, in aiding and abetting cases it was unlikely the plaintiff could establish reliance. Additionally, Justice Kennedy reviewed the history of aiding and abetting, “an ancient criminal law doctrine,” and found that Congress had not enacted a general civil aiding and abetting statute for suits either by the government or by private parties, and when Congress intended to include aiding and abetting in a statute, it did so in express language.

The Central Bank case supports three principles of law under section 10(b) and Rule 10b-5:

- Aiding and abetting cases cannot be sustained under section 10(b), because to do so would allow a plaintiff to recover without showing the plaintiff relied on anything the aider and abettor said or did, and reliance is a mandatory requirement in a civil action under section 10(b).
- In order to have a viable claim for primary liability under section 10(b), the plaintiff must be able to plead and prove each of the required elements of the claim as to each defendant.
- Any person can be liable under section 10(b) as a primary actor if all of the elements of the cause of action are established.

Reliance is not a required element in an enforcement action by the SEC, and SEC power was not at issue in Central Bank, but to clarify the issue, and to respond to Justice Kennedy’s discussion of Congressional history in making aiding and abetting liability statutorily explicit, Congress in 1995 enacted section 104 of the Private Securities Litigation Reform Act (PSLRA or the Reform Act), which is contained
in section 20(e) of the 1934 Act, to clarify SEC enforcement power and make explicit the standard of culpability:

For purposes of any action brought by the Commission under paragraph (1) or (3) of section 21(d), any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

During the fourteen years between Central Bank and the Supreme Court’s 2008 decision in Stoneridge Inc. Partners LLC v. Scientific-Atlanta, Inc., plaintiffs’ attorneys sought a viable theory on which to characterize as primary actors persons who would ordinarily be considered secondary actors. The Ninth Circuit developed a factual “substantial participation” test, which was rejected by the Second Circuit in preference for a “bright-line” test by which it held that auditors who assisted a company with business plans could not be held liable because the auditors did not make any misrepresentation that they knew, or should have known, would reach investors, and the Tenth Circuit chose to follow the bright-line test based on a communication by the defendant. The Eleventh Circuit adopted the substantial participation test, but required the statement to be publicly attributed to the defendant.

A few years before Stoneridge, the SEC’s theory of scheme liability made center stage in one form or another. The argument was that secondary actors who knowingly facilitate securities fraud by engaging in deceptive practices with the primary actor do not merely aid and abet unlawful conduct, but actually commit an independent violation of section 10(b), taking them outside the protection of Central Bank. Thus, in Parmalat, plaintiffs alleged that several banking defendants participated in a scheme to improperly enhance Parmalat’s earnings by engaging in deceptive transactions, including


133. In re Software Toolworks, Inc., 50 F.3d 615 [9th Cir. 1995] (auditors were primary violators where they were members of the offering document drafting group and made misleading statements to the SEC staff during review of the documents); Howard v. Everex Sys., Inc., 228 F.3d 1057 [9th Cir. 2000].

134. Shapiro v. Cantor, 123 F.3d 717 [2d Cir. 1997].

135. Anixter v. Home-State Prod. Co., 77 F.3d 1215 [10th Cir. 1996] (failure to show critical element that the auditor made misrepresentation relied on by investor when defendant knew or should have known it would be relied on).


double-counting receivables and disguising loans as equity transactions. The district court for the Southern District of New York concluded that "where, as alleged here, a financial institution enters into deceptive transactions as part of a scheme in violation of Rule 10b-5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under section 10(b) and Rule 10b-5."\(^{138}\)

The SEC filed an amicus curiae brief in the 2006 Ninth Circuit case, *Simpson v. AOL Time Warner Inc.*,\(^{139}\) which involved allegations of scheme liability against several defendants accused of participating in sham transactions (similar to the round-trip transactions in *Stoneridge*) that allowed Homestore.com to inflate its revenues and deceive its investors before it went out of business. The SEC argued in its brief that primary liability attached to anyone who engages in a "transaction whose principal purpose and effect is to create a false appearance of revenues." The Ninth Circuit was more restrictive than the SEC in holding that "[i]t is not enough that a transaction in which the defendant was involved had a deceptive purpose and effect; the defendant’s own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect."\(^{140}\) "Purpose and effect" was the key phrase associated with scheme liability. The Ninth Circuit’s summary statement was as follows:

> [C]onduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b). Furthermore, such conduct may be in connection with the purchase or sale of securities if it is part of a scheme to misrepresent public financial information where the scheme is not complete until the misleading information is disseminated into the securities market. Finally, a plaintiff may be presumed to have relied on this scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant’s conduct therein, was disseminated into an efficient market and was reflected in the market price."\(^{141}\)

The difficulty with *Parmalat* and *Simpson* is in distinguishing the alleged “schemes” in the transactions at issue with the facts of *Central Bank*, where the trustee bank allowed the developer to delay filing a required certificate (as to the coverage of appraised real estate value over debt service) until after bonds were issued that immediately went...

138. Id. at 510.
139. Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006).
140. Id. at 1048.
141. Id. at 1052.
into default because of the lack of coverage. It is doubtful that, if the conduct of the trustee were characterized as participating in a “scheme” with the developer, the Supreme Court would have decided Central Bank differently. The Ninth Circuit tried to make the distinction by focusing on the defendant’s own conduct as “deceptive,” but there was still the absence of communicative contact between the defendants and the investors that was required by the Second Circuit’s bright-line test. Justice Stevens’ dissent in Stoneridge, described below, argued that there was a clear distinction between the conduct of the trustee in Central Bank (mere aiding and abetting) and the defendants in the scheme liability cases (actual primary participants).

The Fifth Circuit assaulted scheme liability at its weak points in the Enron case, Regents of the University of California v. Credit Suisse First Boston (USA) 142 [Enron]. The action was a consolidation of thirty cases following Enron’s collapse in 2001. Plaintiffs alleged that Credit Suisse First Boston, Merrill Lynch & Company, Inc., and Barclays Bank PLC entered into partnerships and transactions that allowed Enron to take liabilities off its books temporarily and to book revenue from the transactions when it was actually incurring debt. For example, in the frequently cited “Nigerian Barges Transaction,” Enron allegedly wanted to sell electricity-generating barges off the coast of Nigeria so that it could book revenues and meet analyst expectations in 1999. After not finding a legitimate buyer, Enron entered into a sale arrangement with Merrill Lynch in which it guaranteed it would buy the barges back within six months at a premium to Merrill Lynch. Enron did not properly list the transaction as a loan, but as a sale with revenues. The buy-back was by special purpose entities controlled by Enron. Plaintiff investors alleged Merrill Lynch was fully aware of the purpose of the transaction, that each of the other banks entered into similar arrangements, and that although each bank did not know of the specifics of the other banks’ transactions, it knew in general what the other banks were doing and that Enron was engaged in a long-term scheme to defraud investors.

The plaintiffs argued that defendants entered into transactions whose “principal purpose and effect” was to create a false appearance of revenues. The district court had found for the plaintiffs. The Fifth Circuit reversed. The court of appeals focused on the word “deceptive” in the statutory language of section 10(b) that refers to a “deceptive device.” The word “scheme” is not in the statute (it appears in Rule 10b-5[a]), and the Supreme Court had defined a “device,” which is in the statute, to include a scheme. 143 A “deceptive” device must,

142. Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA) [Enron], 482 F.3d 372 [5th Cir. 2007].
143. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 [1976].

(Fippinger, Rel. #18, 7/09) 8–59
therefore, be more than just a scheme. The Fifth Circuit reasoned that for a device to come within the statute, it must clearly be deceptive. “[The Supreme Court] has established that a device, such as a scheme, is not ‘deceptive’ unless it involves breach of some duty of candid disclosure.”144

By implication the Fifth Circuit in Enron was suggesting that the word “scheme” focuses only on the relationships among the defendants, whereas a device or scheme that is deceptive must connect the defendants to the plaintiff investors. Much of that connection is discussed in the opinion by reference to the required showing of reliance, and that aspect of the case will be summarized later in this chapter. Reliance establishes the connection from the perspective of the plaintiff. Deception goes to the defendant’s intended consequences upon the plaintiff investors. The Fifth Circuit thus reasoned that “‘deception’ within the meaning of [section] 10(b) requires that a defendant fails to satisfy a duty to disclose material information to a plaintiff.”145 The Fifth Circuit thereby agreed with the Eighth Circuit in In re Charter Communications, Inc., Sec. Litig.,146 and rejected the scheme liability of the Ninth Circuit. The Fifth Circuit’s Enron decision, the Eighth Circuit’s Charter decision, and the Ninth Circuit’s Simpson decision all resulted in petitions for certiorari. The Fifth Circuit laid out the disagreement with a side-by-side quote of the Eighth and Ninth Circuits:

- Eighth Circuit, Charter:
  “[A]ny defendant who does not make or affirmatively cause to be made a fraudulent statement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.”147

- Ninth Circuit, Simpson:
  “[T]o be liable as a primary violator of § 10(b) for participation in a ‘scheme to defraud,’ the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme.”148

144. Enron, 482 F.3d at 389.
145. Id. at 384.
146. In re Charter Commc’n, Inc., Sec. Litig., 443 F.3d 987 (8th Cir. 2006).
147. Enron, 482 F.3d at 387 [quoting petition for cert. filed July 7, 2006, No. 06-43].
148. Id. [quoting petition for cert. filed Oct. 19, 2006, No. 06-50].
[C] Secondary Actors with Primary Liability After Stoneridge

In Stoneridge, the Supreme Court in 2008 determined to resolve the scheme liability conflict among the Circuit Courts by granting certiorari in respect of the Eighth Circuit’s decision in Charter. Charter, a cable operator, engaged in a variety of fraudulent practices to meet analyst expectations of cable subscriber growth. As part of these practices, the company altered its existing arrangements with two suppliers of digital cable (set-top) boxes, Scientific-Atlanta and Motorola. With Scientific-Atlanta it contracted to overpay $20 for each set-top box it purchased, and with Motorola it agreed to pay $20 in liquidated damages for each set-top box it did not purchase, based on an agreed number of purchases. In contracts with each supplier separated in time [by backdating] from the contracts to purchase set-top boxes, Scientific-Atlanta and Motorola agreed to buy advertising time from Charter at a price higher than fair market value. The payments to Scientific-Atlanta for set-top boxes and the liquidated damages paid to Motorola were capitalized on Charter’s books (on the theory that they were for the purchase of equipment), and the return payments for advertising were booked as revenues. Scientific-Atlanta and Motorola booked the transactions as a wash, in accordance with generally accepted accounting practices, and they did not have any role in preparing or disseminating Charter’s financial statements. Petitioner led a class action alleging that, by participating in the transactions, Scientific-Atlanta and Motorola violated section 10(b).


150. Charter instructed Scientific-Atlanta to notify Charter that it was raising the price of set-top boxes that Charter had already agreed to purchase, and further instructed Scientific-Atlanta to cite higher manufacturing costs as the reason for the increase. Scientific-Atlanta followed Charter’s instructions, even though it knew that the stated reason for the increase was false. The parties later entered into an agreement under which Charter would pay an extra $20 for each set-top box it had already agreed to purchase [totaling $6.73 million in excess payments]. The parties simultaneously entered into a separate agreement in which Scientific-Atlanta agreed to purchase $6.73 million in advertising from Charter [at rates four to five times higher than those paid by other advertisers].

151. Charter entered into an agreement with Motorola to purchase 540,000 set-top boxes by December 31, 2000, even though Charter had no present need for the Motorola boxes [and thus no intention of buying them]. The agreement contained a provision requiring Charter to pay Motorola $20 per box in liquidated damages [totaling $10.8 million] if it did not purchase the boxes by the specified date. The parties entered into a separate agreement in which Motorola agreed to purchase $10.8 million in advertising from Charter [again at rates four to five times higher than those paid by other advertisers].

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Justice Kennedy, writing the majority opinion, summarized petitioner’s argument as follows:

Liability is appropriate, petitioner contends, because respondents engaged in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter’s revenue. The argument is that the financial statement Charter released to the public was a natural and expected consequence of respondents’ deceptive acts; had respondents not assisted Charter, Charter’s auditor would not have been fooled, and the financial statement would have been a more accurate reflection of Charter’s financial condition.\footnote{Stoneridge Inv. Partners, LLC, 552 U.S. at ____, 128 S. Ct. at 770.}

Justice Kennedy began his analysis by reiterating the elimination of aiding and abetting liability under section 10(b) pursuant to \textit{Central Bank}, and by repeating that to state a section 10(b) claim against Scientific-Atlanta and Motorola, the petitioner’s allegations would have to satisfy each of the elements or preconditions for primary liability. The Court held that petitioner’s allegations failed to meet the element of reliance necessary for a section 10(b) claim. The heart of the opinion was reliance, and reliance will be discussed later in this chapter, but this section summarizes the means by which Justice Kennedy separated secondary actors from primary actors. The shift to this analysis is the other side of the reliance coin, because, like reliance, it involves the causal connection between the alleged wrongdoers and the investors. Justice Kennedy, in fact, referred to the importance of the concept of “in connection with” as a fact causation element of a section 10(b) case.

Justice Kennedy emphasized that the conduct of Scientific-Atlanta and Motorola was not communicated to investors, and neither vendor had any duty to inform investors of their participation in the contractual arrangements:

Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents’ deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents’ actions except in an indirect chain that we find too remote for liability.\footnote{Id. at ____, 128 S. Ct. at 769.}

Consideration of conduct that was “remote,” as opposed to conduct that was “immediate,” to the injury informed the holding of the Court:
In all events we conclude respondents’ deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did.\footnote{154}

The Court did react negatively to the possibility that the Eighth Circuit had implied that there must be a specific oral or written statement before there can be liability under section 10(b). Justice Kennedy suggested that the lower court’s opinion that the allegations failed to show that respondents made misstatements relied upon by the public or that they violated a duty to disclose could be read consistently with the Supreme Court’s remoteness approach. After pointing out that conduct can be deceptive, Justice Kennedy stated:

[An] interpretation of the holding from the Court of Appeals’ opinion is that the court was stating only that any deceptive statement or act respondents made was not actionable because it did not have the requisite proximate relation to the investors’ harm. That conclusion is consistent with our own determination that respondents’ acts or statements were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents.\footnote{155}

The Solicitor General of the United States filed an amicus curiae brief supporting Scientific-Atlanta and Motorola with a reliance argument that was very similar to the reasoning of Justice Kennedy.\footnote{156} The Solicitor General, however, bluntly stated that the Eighth Circuit was wrong in concluding that Scientific-Atlanta and Motorola could be liable only for verbal misrepresentations. Rule 10b-5(b) captures misleading statements, but Rule 10b-5(a) and (c), referring to deceptive devices and fraudulent business conduct, can include nonverbal acts:

The court of appeals categorically stated that “any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable on section 10(b)
or any subpart of Rule 10b-5.” . . . The court of appeals thereby appeared to foreclose the possibility that non-verbal deceptive conduct—i.e., deceptive conduct other than misstatements or omissions—could give rise to a violation of section 10(b). The court erred in its analysis in that regard, because a defendant may employ a “deceptive device or contrivance” within the meaning of section 10(b) by engaging in non-verbal deceptive conduct.157

Justice Stevens, dissenting, disagreed with the majority’s analysis of the reliance element of a section 10(b) case, and he also argued that the conduct of Scientific-Atlanta and Motorola was qualitatively different from that of the municipal bond indenture trustee in Central Bank. Justice Stevens characterized the Central Bank trustee’s activity as a “delay in reviewing a suspicious appraisal,” and the delay did not constitute deception:

What the Court fails to recognize is that this case is critically different from Central Bank because the bank in that case did not engage in any deceptive act and, therefore, did not itself violate § 10(b) . . . the fact that Central Bank engaged in no deceptive conduct whatsoever—in other words, that it was at most an aider and abettor—sharply distinguishes Central Bank from cases that do involve allegations of such conduct.158

After stating that Central Bank did not engage in deceptive conduct, Justice Stevens hypothesized conduct by Scientific-Atlanta and Motorola that he believed would not have been deceptive, and conduct of the Central Bank trustee that he considered would have been deceptive:

The facts of this case would parallel those of Central Bank if respondents had, for example, merely delayed sending invoices for set-top boxes to Charter. Conversely, the facts in Central Bank would mirror those in the case before us today if the bank had knowingly purchased real estate in wash transactions at above-market prices in order to facilitate the appraiser’s overvaluation of the security.159

Immediately after deciding Stoneridge, the Supreme Court denied the petition for certiorari in the Enron case, leaving in place the Fifth Circuit decision that denied scheme liability. Certiorari was granted in Simpson, and the case was reversed and remanded to the Ninth Circuit for further proceedings consistent with Stoneridge. Scheme

157. Id.
158. Stoneridge Inv. Partners, LLC, 552 U.S. at ____, 128 S. Ct. at 775 [Justice Stevens dissenting].
159. Id. at ___, 128 S. Ct. at 775 [Justice Stevens dissenting].

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liability was clearly hobbled by *Stoneridge*,\(^{160}\) but the issue that is alive is conduct that would render a person a primary violator after *Stoneridge*. Justice Stevens's hypotheticals can be pursued to consider conduct by Scientific-Atlanta and Motorola that might satisfy Justice Kennedy. As a factual matter, the transactions involving the improper booking of revenues for the advertising payments by Scientific-Atlanta and Motorola was only a small part of the fraudulent bookkeeping by Charter Communications, and the small proportion had the effect of diminishing the impact of any actual reliance. If the transactions with the respondents were the only improper conduct by Charter, and if Scientific-Atlanta and Motorola had appeared at a press conference with Charter to announce the new advertising agreements, the behind-the-scenes conduct of respondents might be considered sufficiently “immediate” to investors to constitute deceptive conduct under the majority opinion of Justice Kennedy.\(^{161}\)

[D] **Bond Counsel As a Primary Actor After *Stoneridge***

*Stoneridge* is generally interpreted to mean that “background” people in financial as well as commercial transactions—including banks that create financial arrangements, such as the asset sales in *Enron* (but not underwriters of securities offerings), and the lawyers who draft the documents for the arrangements—are not liable in a private cause of action under section 10(b), because their causal connection with investors is too attenuated to satisfy the reliance requirement. The generalization is subject to the circumstances of each case and the actual role played by bankers, lawyers, and accountants. In public finance, one lawyer who is vulnerable to being considered a primary actor, both before and after *Stoneridge*, is the law firm acting as bond counsel, and it is useful to consider whether *Stoneridge* affects the potential civil liability of bond counsel in an action brought under section 10(b).

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161. In Burnett v. Rowzee, 561 F. Supp. 2d 1120 [C.D. Cal. 2008], a district court in the Ninth Circuit decided a case a few weeks after *Stoneridge* in which it continued to use the term “scheme liability” and the Ninth’s Circuit’s “purpose and effect” language. The court reviewed a series of activities by one of the promoters of an alleged Ponzi scheme, and found several of the activities to be in the background and not deceptive under *Stoneridge*, but also found that certain activity by the defendant involving direct contact with investors as a promoter of the fraudulent scheme did satisfy the deceptive standard of *Stoneridge*. 
To test this proposition, the facts of the SEC’s enforcement action against Ira Weiss, a Pittsburgh bond attorney, may serve as a hypothetical. The enforcement action in 2005–06 predated Stoneridge. The SEC instituted the proceeding for a cease-and-desist order under both the 1933 Act and the 1934 Act, alleging Weiss violated the antifraud provisions of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act for misrepresentations in the official statement, the arbitrage closing certificate, his approving opinion as bond counsel, and a supplemental opinion in connection with $9.6 million principal amount of notes issued on a tax-exempt basis by the Neshannock Township School District in northwestern Pennsylvania. After the closing on the notes, the Internal Revenue Service issued a preliminary determination that the notes were taxable because they violated the arbitrage provisions of section 148 of the Internal Revenue Code. The school district and the IRS subsequently entered into a closing agreement that, on the basis of payment obligations to the IRS imposed on the school district, preserved the tax-exempt status of the notes.

The notes were determined to be in violation of the arbitrage provisions of the Code because the school district, in the opinion of the IRS, had issued the notes without any reasonable expectation to expend the proceeds on capital projects. The investment banker for the school district, Andrew Shupe, president of Quaestor Municipal Group, Inc., a Pittsburgh broker-dealer firm formed eleven years before the financing was promoted, allegedly intended for the school district to arbitrage the note proceeds by investing in U.S. Treasury obligations (at yields higher than the yield on the notes) without any legitimate expectation of spending the proceeds on capital projects. Both Shupe and the school district consented to SEC cease-and-desist orders.


164. Under the relevant federal tax law provisions, issuers of tax-exempt debt for capital projects must reasonably expect on the date of issuance to satisfy certain “spend-down requirements.” These spend-down requirements include (1) within six months of the date of issuance, incurring a binding obligation to a third party to expend at least 5% of the net proceeds on capital projects, (2) proceeding with due diligence on the capital projects until completion, and (3) expending within three years at least 85% of the net proceeds of the borrowing on capital projects. Under the relevant IRS regulations, an issuer’s expectations are considered reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations, based on all the objective facts and circumstances.


Weiss, the bond counsel, refused to consent, and his case was heard before an administrative law judge. The Division of Enforcement alleged that Weiss violated the antifraud rules by making several misrepresentations and omissions during his course of representation in the note transaction. According to the Division, Weiss knew, or was reckless in not knowing, that the notes were issued for the purpose of illegal arbitrage profits when he (1) reviewed the official statement, which represented that the notes were issued to finance capital projects, (2) issued his approving opinion that the notes were tax-exempt, and (3) issued his supplemental opinion to the effect that nothing had come to his attention that led him to believe the official statement was materially inaccurate or incomplete. The twenty-two-page decision of the administrative law judge contained extensive findings of fact, and held: “I conclude the School District did not issue the Notes solely for the purpose of obtaining arbitrage profit. I also conclude that Weiss did not act recklessly, or negligently, during the course of his representation of the School District for the Note Transaction.”

The Division of Enforcement appealed the administrative law judge’s dismissal of the proceeding against Weiss to the SEC. Based on its independent review of the record, the Commission (in a twenty-seven-page opinion) reversed the administrative law judge’s decision and entered a cease-and-desist order based on violations of section 17(a)(2) and 17(a)(3) of the 1933 Act, but not on section 10(b) and Rule 10b-5 of the 1934 Act. There are three important conclusions in the Commission’s opinion that are relevant to this discussion of the Weiss facts for purposes of a post-Stoneridge hypothetical case study of the likelihood of bond counsel being treated as a primary actor:

• “Weiss is primarily liable for his role in the Note issue. Weiss reviewed and approved the Official Statement, which misrepresented that Note proceeds would be used to fund school construction projects. Weiss also rendered an unqualified bond opinion, reinforced by a second supplemental opinion, that misrepresented the risk that interest on the Notes would be taxable. The Official Statement referred to Weiss’s unqualified opinion that interest on the Notes would be tax-exempt. Weiss knew the statements in the Official Statement and in his legal

opinions were communicated to, and relied on, by prospective investors in deciding whether to purchase the Notes. 169

• “Weiss was responsible for misrepresentations and omissions in the Official Statement and in his legal opinions which were made available to investors. Weiss's conduct caused harm to investors who purchased the Notes because they were without full information concerning the substantial risk that the IRS would find the Notes to be taxable. Weiss's conduct also caused harm to the marketplace by eroding confidence in bond counsels' unqualified opinions. The importance that investors place on such opinions cannot be overestimated.” 170

• “Weiss was responsible for misrepresentations and omissions in the Official Statement and in his legal opinions regarding the School District’s use of the Note proceeds and the Notes’ nontaxable nature. Weiss's liability stems from making those misrepresentations and omissions without conducting adequate inquiries, and not on any failure to discover the fraud.” 171

Weiss petitioned the Court of Appeals for the District of Columbia Circuit for judicial review of the Commission’s order. The court of appeals denied the petition, which left standing the order of the Commission. 172 The three segments of the Commission’s findings above on Weiss’s responsibilities may be supplemented by two conclusions of the court of appeals on the significance of the legal opinions delivered by Weiss:

• “Because the Treasury regulations look to whether the issuer reasonably expected to satisfy the three tests ‘as of the issue date,’ not to whether it actually satisfied them later, there is potential for abuse. To assuage the concerns of investors, issuers retain bond counsel to provide an unqualified legal opinion that the interest on the bonds will be exempt from federal taxation. According to the National Association of Bond Lawyers, the purpose of an unqualified bond opinion is to assure[] investors that . . . there is no reasonable risk of . . . taxability that the investors should take into account in making an investment decision, except for risks disclosed in the opinion.” 173

169. Id. at 19.
170. Id. at 26.
171. Id. at n.38.
172. Ira Weiss v. SEC, No. 06-1001 [D.C. Cir. 2006].
173. Id. [citing NATIONAL ASSOCIATION OF BOND LAWYERS, STATEMENT CONCERNING STANDARD APPLIED IN RENDERING THE FEDERAL INCOME TAX PORTION OF BOND OPINIONS (1993)].
• “Weiss also prepared two documents addressed ‘To the purchasers of the . . . Bonds.’ The first document was an opinion letter dated June 28, 2000, in which Weiss represented that his opinions were based on his examination of ‘certain statements, certifications, reports, affidavits, documents and agreements pertaining to the issuance and sale of the Notes.’ Weiss then stated: ‘Under existing statutes regulations and decisions, interest on the Notes . . . is excluded from gross income for purposes of Federal income taxation . . . . Furthermore, the Notes are not arbitrage bonds.’ Because Weiss did not mention any risk that interest on the bonds might be taxable, his bond opinion was ‘unqualified.’ The second document was a supplemental opinion letter also dated June 28, 2000. In this letter, Weiss stated: ‘Nothing has come to my attention in the course of my professional engagement in connection with the Notes which has led me to believe that the Official Statement contains any untrue statements [or omissions] of a material fact.”\(^{174}\)

The issue for purposes of this discussion is whether a bond counsel is likely to be viewed by a court as a primary actor after *Stoneridge* in a private cause of action using the Weiss facts as a hypothetical. As a preliminary matter, it must be recognized that the elements of a private cause of action that are required to be pleaded by a private plaintiff are significantly more extensive than the pleading requirements for the SEC, and the SEC has considerable flexibility in pursuing secondary actors under the securities laws. A private litigant is obligated to show loss causation and damages, which is problematic when an issuer, like the school district in *Weiss*, enters into a settlement agreement with the IRS to pay over arbitrage profits to the United States in consideration of the IRS’s continuing to treat the securities as tax-exempt. A private litigant is required to plead scienter under section 10(b) and Rule 10b-5, whereas the Division of Enforcement, after losing before the administrative law judge pleading both

\(^{174}\). *Id.* Supplemental opinions of bond counsel on matters relating to the official statement, like the opinion of underwriter’s counsel, are ordinarily addressed to the underwriter on limited matters in relation to disclosure as requested by the underwriter, in order to assist the underwriter in fulfilling its due diligence obligation. Because these opinions are limited to fulfill a specific objective of the underwriter, they usually are not addressed to any party other than the underwriter to avoid any implication the opinion is to be interpreted more broadly than its express purpose. An opinion on disclosure by Weiss addressed to “the purchasers of the . . . Bonds” was outside the customary practice, and it was uniquely broad in referring to the entire official statement rather than a limited portion as would ordinarily be requested by an underwriter regarding the subjects uniquely within the expertise of bond counsel.
section 10(b) scienter and 1933 Act section 17(a)(2) and (3) negligence, was able to simply drop scienter and plead mere 1933 Act negligence before the Commissioners of the SEC.

There were two other advantages of the SEC, when compared to the pleading requirements of a private litigant, that are important to the usefulness of the facts to this case study. The SEC was not obligated to treat Weiss as a primary actor, but it did. Secondly, the SEC, unlike a private litigant, is not obligated to plead reliance, but it did not emphasize this difference. In treating Weiss as a primary actor, the SEC Commissioners cited the SEC’s position in the Ninth Circuit (Weiss predated Stoneridge), and, therefore, the case raised the Stoneridge issues. For purposes of the hypothetical, it will be assumed that plaintiff need not plead damages, and the only issue is whether Weiss could be considered a primary actor upon whom investors relied in a private cause of action brought after Stoneridge.

The role played by bond counsel in public finance does not have any counterpart in corporate finance. In a 1993 publication by sections of the American Bar Association and the National Association of Bond Lawyers, the historical role of bond counsel in public finance, dating to nineteenth-century reactions to widespread repudiation and default of municipal securities, was succinctly summarized:

Bond counsel is a unique role present in virtually every municipal securities transaction. Bond counsel are not present in any other type of securities offerings. Bond counsel have played a prominent role in municipal finance since the late 19th century, when their presence in public financings was demanded by investors largely as the result of various judicial decisions invalidating state and local government bond issues on constitutional and other grounds . . . . Those lawyers were called upon to review the proceedings and documents and give assurance to the investors that the bonds were valid and that the rights conferred upon investors by those bonds were enforceable.

When bonds were issued in bearer form, the bond counsel opinion was ordinarily printed on the back of every $1,000 or $5,000 denomination bond in order to circulate with each transfer of securities. The

175. SEC, Cease and Desist Order, 1933 Act. Rel. No. 8641 (Dec. 2, 2005), text at n.32.
176. Id. at n.32.
177. SUBCOMMITTEE ON MUNICIPAL AND GOVERNMENTAL OBLIGATIONS, COMMITTEE ON FEDERAL REGULATION OF SECURITIES, ABA SECTION OF BUSINESS LAW, ABA SECTION ON URBAN, STATE AND LOCAL GOVERNMENT LAW, AND NATIONAL ASSOCIATION OF BOND LAWYERS, DISCLOSURE ROLES OF COUNSEL IN STATE AND LOCAL GOVERNMENT SECURITIES OFFERINGS 11 (2d ed. 1993) [emphasis added].
opinion of bond counsel is today customarily reproduced at the back of the official statement and its absence would raise concerns among investors. An opinion of bond counsel for more than a century has been a condition of closing, a marketplace requirement for "good delivery," and the cover of the official statement expressly states that the bonds are offered when, as, and if issued and subject to the approving opinion of bond counsel:

This long established use of the bond opinion in the marketing of bonds means that bond counsel (1) cannot effectively deny knowledge that the opinion is relied upon by purchasers of the securities, and (2) must be cautious that no unintended implications about disclosure can be fairly read into the opinion. The use of the bond opinion in the marketing of the bonds is pervasive and ongoing. . . . The bond opinion differs from other opinions delivered in connection with the offering of municipal securities in three important respects. First, bond opinions are either addressed to or intended to be relied upon directly by investors, while other opinions are addressed only to, and authorize reliance on the opinion only by, other participants to the offering. The bond opinion is intended to be used by investors in evaluating the merits and risks of an investment in the securities. Second, since the bond opinion is a condition to "good delivery" on the securities, it is itself prominently disclosed in the offering document, often by reproduction of a copy of the opinion as an appendix. Other types of opinions are referred to only in passing, if at all.178

If the bullet points above from the SEC and D.C. Court of Appeals opinions are read with the two quotes from the Disclosure Roles of Counsel and measured against the opinion of the Supreme Court, it should be clear that bond counsel would be viewed as a primary actor whose conduct and statements are relied upon by investors in municipal securities.

[E] Aider and Abettor Liability Under State Law

Lawyers in a public finance transaction, such as issuer’s counsel and underwriters’ council, may be too far in the background to have primary actor exposure comparable to bond counsel after Stoneridge, but may still be subject to aider and abettor liability under state law.179 In addition, after Central Bank, Congress added section 20(e) to the 1934 Act to authorize aider and abettor liability in actions brought by the SEC, but not by private parties under the 1934 Act. Private litigants are thus precluded from bringing an action against aiders and abettors

178. Id. at 149–50 (emphasis added).

(Fippinger, Rel. #18, 7/09) 8–71
under section 10(b), but, in dicta, Justice Kennedy acknowledged in his Stoneridge majority opinion that some state laws provide remedies against aids and abettors.

An action brought under a state aiding and abetting statute may, however, be barred by the 1998 Securities Litigation Uniform Standards Act (SLUSA). SLUSA gives federal courts the exclusive jurisdiction, and makes federal claims the exclusive claims, for large-scale class actions where a private party alleges (1) an untrue statement or omission in connection with the purchase or sale of a “covered security,” or (2) that the defendant used a manipulative or deceptive device in connection with a transaction. SLUSA’s preemptive power was held by a New Jersey district court to be sufficiently strong to preempt an aiding and abetting claim brought in state court even though under federal law the plaintiff would have no remedy due to Central Bank.\(^{180}\)

Section 28(f) of the 1934 Act, which incorporates the provisions of SLUSA applicable to the 1934 Act, defines covered class actions and covered securities, and if there is not a covered class action (e.g., damages are sought on behalf of fewer than fifty persons) or there is not a covered security, a claim can be brought in state court for aider and abettor liability. Covered securities are defined by cross-reference to paragraphs (1) and (2) of section 18(b) of the 1933 Act, and, since 1933 Act section 3(a)(2) municipal securities are under paragraph (4) of the section 18(b) definition of covered securities, the 1934 Act preemption will not ordinarily apply to section 3(a)(2) exempt securities.\(^{181}\)

Houston v. Seward & Kissel, LLP\(^{182}\) was a 2008 diversity jurisdiction case brought in the district court for the Southern District of New York by an Oregon resident against a New York law firm as an aider and abettor of a securities fraud under Oregon securities law. The case involved alleged material misstatements and omissions in the offering documents for Wood River Partners, L.P., a hedge fund in which plaintiff lost a $2.75 million investment. The prospectus, which listed Seward & Kissel as counsel to Wood River, made specific representations about the diversification of fund investments. The fund, in contravention of the representations, invested primarily in a single technology company that declined in value to the point that Wood River was unable to honor redemptions, and was placed in receivership. The claim was filed against Seward & Kissel because the firm drafted the offering documents that allegedly contained false

\(^{180}\) LaSala v. Bordier et Cie, 452 F. Supp. 2d 575 [D.N.J. 2006].

\(^{181}\) But see the discussion, earlier in this chapter, of possible application of SLUSA preemption to private activity bonds guaranteed by a corporation with parity securities traded on an exchange.

\(^{182}\) Houston v. Seward & Kissel, LLP, No. 07-cn-6305 [H.B.] [S.D.N.Y. Mar. 27, 2008].
representations about the fund manager, who was sentenced to thirty-six months' imprisonment. Plaintiff further alleged that the law firm aided in a fraudulent sale of securities “because it drafted, edited and/or reviewed and approved the prospectus and marketing materials.” The Oregon securities law contains a provision virtually identical to Rule 10b-5, but, unlike Rule 10b-5, there is a subsequent section that expressly provides for aider and abettor liability:

Any person who violates or materially aids in a violation of [the antifraud statute] is liable to any purchaser or seller of the security for the actual damages caused by the violation . . . unless the person who materially aids in the violation sustains the burden of proof that the person did not know, and, in the exercise of reasonable care, could not have known of the existence of the facts on which the liability is based.

Defendant law firm filed a motion to dismiss on the theory of federal preemption—not under SLUSA, because the case was not a class action, but under the 1996 National Securities Markets Improvement Act [NSMIA]. NSMIA, which is incorporated into section 18 of the 1933 Act as discussed earlier in this chapter, provides that certain securities offerings are exempted from state law regulation in terms of registration and reporting requirements. The theory underlying the motion to dismiss was that the claim of material misrepresentations and omissions related to the prospectus, and all matters related to the substance of the prospectus were preempted. If courts reviewed the substance of disclosure through the backdoor of antifraud litigation under state law, NSMIA would be rendered ineffective. The motion to dismiss was denied because section 18(c) specifically provides that states are to retain jurisdiction “to investigate and bring enforcement actions with respect to fraud or deceit,” and the court concluded more broadly that it found “nothing in the history of [NSMIA] that preempts state oversight of fraud or deceit in the securities realm.”

State law generally provides that a party may be regarded as an aider and abettor of fraud if the following requirements are satisfied:

1. the existence of an underlying fraud;
2. knowledge of this fraud on the part of the aider and abettor;

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183. OR. REV. STAT. § 59.135.
184. OR. REV. STAT. § 59.137(1).
185. See Rapp & Berckmueller, Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure, 63 BUS. LAW. 809 [May 2008].

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(3) *substantial assistance* by the aider and abettor in perpetration of the fraud.

There must be an underlying fraud by a person other than the aider and abettor, such as materially misleading statements by an issuer of municipal securities in an official statement.\(^{186}\) To a large extent, liability as an aider and abettor concerns a particular state of mind by the aider and abettor. Knowledge of the fraud means *scienter*, and it has been held that the plaintiff must allege sufficient facts to support a “strong inference of fraudulent intent.”\(^{187}\) There must be more than merely providing assistance, as when issuer’s counsel or underwriter’s counsel “keeps the master” in working group drafting sessions. The alleged aider and abettor must know that, for example, an issuer’s proposed language for an official statement in a drafting session is wrongful, and that by endorsing the proposed language the alleged aider and abettor knew the fraud was being assisted. Simply agreeing to language that is known to be misleading is probably insufficient, because the third requirement for liability, which is “substantial assistance” in perpetration of the fraud, implies more than simply acting as the scrivener in a working group session on the official statement. An affirmative act of assistance might include the following: In a working group meeting on the official statement, X, an officer of the issuer, states to Y, the issuer’s counsel, “You send around a draft to the group on the ‘use of proceeds’ section because you know how I want it drafted.” Y knows that X does not intend to use the proceeds of the bonds for capital projects as required by the arbitrage provisions of the Code, but that X is willing to sign an arbitrage certificate at closing stating an expectation of using proceeds for capital projects. Y drafts the use of proceeds section for the official statement, falsely indicating the issuer’s intent to finance capital projects. Y is probably an aider and abettor of X, the primary violator.

### § 8:3.3 Antifraud Jurisdiction over Swap Transactions

**[A] Security-Based Swap Agreements**

Section 10(b) of the 1934 Act makes it unlawful for any person to use any deceptive device in connection with the purchase or sale of any security “or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act).” Section 17[a] of the 1933 Act makes it “unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in

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186. *In re AHT Corp.*, 292 B.R. 734, 746 (S.D.N.Y. 2003), aff’d, 123 F. App’x 17 (2d Cir. 2005).

section 206B of the Gramm-Leach-Bliley Act)" to engage in any of the enumerated fraudulent activities. The addition of interest-based swap agreements to securities in these two antifraud statutory provisions was made by amendments to the securities and commodities laws under the Commodities Futures Modernization Act of 2000, which was enacted to settle jurisdictional disputes between the SEC and the Commodities Futures Trading Corporation (CFTC) over derivative and hybrid products.

Title III of the 2000 Modernization Act is entitled “Legal Certainty for Swap Agreements.” The title adds section 2A to the 1933 Act and section 3A to the 1934 Act, each entitled “Swap Agreements.” Section 2A of the 1933 Act provides that the definition of a security in section 2(a)(1) does not include either a non-security-based swap agreement or any security-based swap agreement, and prohibits the SEC from imposing any registration or reporting requirements on security-based swap agreements. Section 3A of the 1934 Act provides that the definition of a security in section 3(a)(10) does not include any security-based swap agreement and prohibits the SEC from requiring 1934 Act registration of any security-based swap agreement. In effect, the SEC is limited to antifraud jurisdiction in respect of security-based swap agreements, but the SEC does not have antifraud jurisdiction over non-security-based swap agreements.

Section 301 of the 2000 Modernization Act amends Title II of the Gramm-Leach-Bliley Act by adding a section 206A definition of a swap agreement. Section 206B defines a security-based swap agreement as follows:

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190. The definition of the term “swap agreement” has five parts, including:

[3] provides on an executory basis for the exchange, on a fixed or contingent basis, of one or more payments based on the value or level of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise of investment pool) or liability that incorporates the financial risk so transferred, including any such agreement, contract, or transaction commonly known as an interest rate swap, including a rate floor, rate cap, rate collar, cross-currency rate swap, basis swap, currency swap, equity index swap, equity swap, debt index swap, debt swap, credit spread, credit default swap, credit swap, weather swap, or commodity swap.
As used in this section, the term “security-based swap agreement” means a swap agreement (as defined in section 206A) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.

Section 206C defines a non-security-based swap agreement as follows:

As used in this section, the term “non-security-based swap agreement” means any swap agreement (as defined in section 206A) that is not a security-based swap agreement (as defined in section 206B) . . .

SECURITY DEFINITION – As used in the amendment made by subsection [a], the term “security” has the same meaning as in section 2[a][1] of the Securities Act of 1933 or section 3[a][10] of the Securities Exchange Act of 1934.

In public finance, interest rate swap agreements are contracts between two parties to exchange cash flows calculated on the basis of the product of a fixed or floating rate and a set notional amount. There is no exchange of principal payments. Swap agreements have generally not been regulated as securities because they involve contracts between two counterparties where the gains of one are the losses of the other, and, accordingly, they do not involve a “common enterprise” traditionally associated with investment securities. The floating rate portion of the contract may incorporate a variety of indices, including the London Interbank Offered Rate (LIBOR), the T-Bill rate, the CPI, or the SIFMA index.

The issue of a LIBOR-based swap agreement as a security-based swap agreement for purposes of a section 10[b] antifraud action was raised in St. Matthew’s Baptist Church v. Wachovia Bank, National Association, a 2005 case in the federal district court for New Jersey. The church sought a fixed-rate, five-year, long-term loan from Wachovia to take out its short-term construction loan from that bank. The bank advised the church it did not qualify for a fixed-rate loan and recommended a floating loan with a fixed-rate hedge through a swap agreement. The church and Wachovia entered into a swap agreement with the floating rate tied to LIBOR. Two years into the agreement, interest rates had declined, and the church determined to prepay the loan with Wachovia and refinance with another bank at

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The church alleged that it then learned, for the first time, that there would be a significant “termination fee” for the termination of the swap agreement at the time of prepayment of the loan note. The church claimed an omission of a material fact in connection with the sale of a security-based swap agreement.

The district court decided for the bank, holding that the swap agreement was a non-security-based swap agreement outside the reach of section 10(b). The court took judicial notice of information derived from the British Bankers’ Association, which is charged with compiling the LIBOR, to the effect that “Libor stands for the London Interbank Offered Rate and is the rate of interest at which banks borrow funds, in marketable size, in the London interbank market.” Since LIBOR is based on interest rates and not the “price, yield, value or volatility of any security or any group or index of securities, or any interest therein,” the court concluded LIBOR does not give rise to a security-based swap agreement.

The reasoning of St. Matthew’s Baptist Church was amplified in a 2009 decision by the district court for the Southern District of New York in School District of the City of Erie v. J.P. Morgan Chase Bank granting the bank’s motion to dismiss and adopting the statement of law in St. Matthew’s Baptist Church. The swap agreement was fixed-for-floating-rate based on LIBOR. Plaintiff tried to distinguish the church’s swap agreement on the grounds that one side of the church swap agreement was based on the fixed rate of a commercial loan, which is not a security, whereas in Erie School District one side was based on the interest rate of a previously issued municipal bond. The court said:

[H]ere, the underlying fixed interest rate, which is the reference point, is the interest rate payable on the previously issued bonds. The floating interest rate, and, thus, for the purposes of the swap, the only material term, is not based on the price, yield, value, or volatility of any security, or any group, or index of securities, but, rather is based upon the LIBOR rate, that is, an interest rate. Accordingly, this swap is not a securities based swap agreement, and, thus, is a nonsecurities based swap agreement, not subject to Section 10(b).

In reaching this conclusion, the district court cited the 2007 decision of an administrative law judge in a proceeding that reviewed

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193. The district court added that the complaint failed to meet the pleading requirements of PSLRA to specify the reasons why the omissions were misleading and the particular facts that give rise to a strong inference the defendant acted with scienter.

194. Sch. Dist. of City of Erie v. J.P. Morgan Chase Bank, No. 08-CV-07688 (Jan. 21, 2009).

(Fippinger, Rel. #18, 7/09) 8–77
a number of transactions to determine whether they were municipal securities business for jurisdiction of the MSRB Rules. The administrative law judge commented:

The Division [of Enforcement] also maintains that [certain] swap proposals “included” primary offerings of municipal bonds, and therefore were “municipal securities business” for that reason. It is unclear if the Division is asking the Commission to assert jurisdiction over such transactions in their entirety, or only over the bond aspect of these proposals. I agree with Respondents that, while an issuer might enter into a swap transaction or a swaption at the same time as it enters a bond offering, the contemporaneous nature of the two transactions does not make them a single financial instrument with a bond component. If a swap-based proposal merely contemplates that the issuer might offer refunding bonds at some point in the future, then the MSRB and the Commission would not exercise present jurisdiction over the transaction. Rather, they would assume jurisdiction only when and if the refunding bond offering becomes a reality. It is difficult to be more specific without reviewing the transactional documents, but the parties have not offered them as exhibits.

[B] Swap Agreements Entered into “in Connection with” the Sale of Municipal Securities

Assume that a commercial bank convinces a school district to issue variable-rate securities because there is a strong demand by money market funds for variable-rate securities, and the school district will, therefore, be able to enter into a fixed-rate hedge through a swap agreement with the bank at a lower net interest cost than if it had originally issued fixed-rate bonds. The fixed-rate side of the swap agreement is the interest rate the school district would have paid if it had issued fixed-rate bonds less ten basis points, and the variable-rate side is based on LIBOR. The swap agreement is presumably not a security-based swap agreement. The bank fails to disclose to the issuer that it is insolvent and a significant counterparty risk. The variable-rate bonds are issued, the swap agreement is executed, and shortly thereafter the bank collapses with a resulting economic loss to the school district. The school district brings an action against the bank receiver, not in connection with the swap agreement, which is a non-security-based swap agreement, but for fraud in connection with the sale of the variable-rate bonds.


196. Id. at 42.
The variable-rate bonds are not in default. There are no material misstatements or omissions in the official statement about the bonds, although the official statement contains a paragraph stating the expectation to enter into the swap agreement as a hedge. The risk of the variable rate, however, is unaffected by the counterparty default on the swap. The damages to the school district are thus contract law damages related to the cost of unwinding the swap agreement and negotiating a new swap agreement with a solvent counterparty. The tightness of the “in connection with” argument that the fraud was in connection with the sale of the bonds should be sufficient for the school district to prevail, despite the swap agreement being a non-security-based swap agreement. The analysis relies on the Supreme Court decisions in *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*\(^{197}\) and *SEC v. Zandford,\(^{198}\) discussed earlier in this chapter in the section on “in connection with” as a determining factor. The defendant in *Wharf* argued that a supposed securities law case was actually a contract law case because the dispute related to the defendant’s failure to perform on an agreement to deliver securities in payment for services, but, as stated in the amicus brief of the SEC, “a misrepresentation is made ‘in connection with the purchase or sale of any security’ when the misrepresentation and the securities transaction are part of the same fraudulent scheme.”\(^{199}\) In *Zandford*, the respondent’s sale of the customer’s securities was perfectly lawful, but the respondent broker-dealer then misappropriated the proceeds, and the court concluded the legitimate sale of securities and the theft of the proceeds were part of the same transaction.\(^{200}\) It follows that a simultaneously issued securities offering and execution of a swap agreement may be considered as part of the same transaction for purposes of a single fraudulent scheme under the “in connection with” requirement.

**§ 8:4 Materiality**

**§ 8:4.1 Cases in Which the Materiality Element Is Not Applicable**

Section 10[b] of the 1934 Act does not use the word “material.” The section refers to “any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.” Rule 10b-5 parses manipulative and deceptive devices into three categories: (a) any device, scheme or artifice to defraud,
(b) any untrue statement of a material fact or omitting to state a material face necessary to make statements made not misleading, and (c) any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. Alleged “material” misstatements and omissions under Rule 10b-5(b) dominated anti-fraud litigation until scheme liability became popular with plaintiffs’ attorneys after Central Bank had curtailed section 10(b) civil liability for aiders and abettors. In fact, the predominance of Rule 10b-5(b) has been such that recitations of the elements of a section 10(b) case routinely have begun with “[1] a material misrepresentation . . . .”

The classic case of nonverbal deceptive conduct is market manipulation. If a group of underwriters of a new issue of municipal securities were to buy and sell the securities among themselves during the distribution period to create the illusion of strong demand for the securities, and the trading is outside the bounds of legitimate price stabilization, the manipulative conduct could be actionable under Rule 10b-5(a) and (c). The manipulation itself is deceitful without the necessity of proving a material misstatement or omission. The backdating of contracts in Stoneridge to falsely allow accounting treatment as an equipment purchase, rather than a wash transaction with advertising revenues, was nonverbal conduct that could have resulted in Rule 10b-5(a) or (c) liability, except for the fact that the Supreme Court found there was no reliance on the conduct.201 If a purchaser of municipal securities that are being manipulated to raise the price and create a sense of false demand relies on the deceptive conduct in making an investment decision, there can be a section 10(b) cause of action without showing a material misrepresentation.

In various sections of this chapter there will be an organizational distinction made among

1. disclosure fraud, relating to statements in the prospectus or official statement as well as in continuing disclosure materials;
2. concealment fraud, referring to concealments or omissions of information in the context of insider trading;
3. transaction fraud, which involves courses of business conduct having an effect on the economic expectations of investors;
4. fiduciary fraud, referring to nondisclosures of information to issuers or other beneficiaries of a fiduciary relation; and

(5) markup fraud, referring to nondisclosure of excessive markups of the price of securities sold to issuers.

Disclosure fraud, concealment fraud, fiduciary fraud, and markup fraud are likely to give rise to an action under Rule 10b-5(b), which refers to the making of an untrue statement of a material fact or the omission of a material fact. In such actions, the focus is on the “materiality” of the misstatement and the culpability of the defendant. Transaction fraud is likely to trigger actions brought under Rule 10b-5(a) and (c), which refer to devices, schemes, practices, or a “course of business that operates or would operate as a fraud or deceit upon any person.”202 Materiality is generally viewed as an element of all Rule 10b-5 actions despite the absence of the term in Rule 10b-5(a) and (c). Materiality is likely to appear in subsections (a) and (c) surreptitiously. For example, in a transaction fraud case brought under Rule 10b-5(a) and (c), the materiality concept may appear under the objective test of the causation requirement that the act complained of was a substantial factor in causing plaintiffs harm. Likewise there may be a connection between a later transaction and an earlier disclosure. If the disclosure at the time of a new issue clearly describes the possibility of the occurrence of the later transaction, which is being challenged as a fraudulent scheme, the likelihood that the transaction will be fraudulent is significantly reduced.

Nevertheless, concepts of materiality have the most significance in the cases of affirmative statements (or omissions), either in a distribution or in continuing disclosure, in concealments of information while trading, and in the market integrity cases involving fiduciary and related concepts. Rule 10b-5(b) requires scrutiny of the context of the misstatement or omission. The misstatement or omission must be of a material fact. A material fact is a fact that is necessary in order to make the statements made, “in the light of the circumstances under which they were made,” not misleading. This statutory contextual

202. Rule 10b-5 provides:

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

[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 the light of the circumstances under which they were made, not misleading, or

[c] To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

provision modifying the common law elements of deceit is easily overlooked although invariably included in lawyers’ opinions. One consequence of the language in Rule 10b-5(b) is that a fact pattern might be more easily analyzed as transactional fraud than as disclosure, concealment, or fiduciary fraud.

For example, a revenue bond issue is likely to provide in the trust indenture that, upon the occurrence of an event of default, the trustee is empowered to accelerate the payment of principal and interest. Acceleration clauses make the outstanding balance of principal, together with accrued interest, immediately due and payable. There has been discussion about the use of acceleration clauses in refunding transactions to avoid redemption premiums, which usually are required in advanced refundings with escrows timed to a call date. By combining the refunding with an intentional default and acceleration, the issuer can in effect transform a premium call into a par call. The disclosure of acceleration in official statements, if mentioned at all, is customarily part of the summary of the trust indenture and is included among the discussion of other remedies upon default. The question arises whether the possibility of an “acceleration call” should be highlighted in the redemption section of the official statement as one of the circumstances in which there may be a par call.

The answer clearly should be in the negative. At the time the old bonds were issued, it is very unlikely that the issuer contemplated an intentional default. If such a default had been contemplated, the bonds probably would have been illegally issued under statutory authority. “In the light of the circumstances” in which the first official statement was prepared, it would not be appropriate to require the preparers of the disclosure document to speculate about future possibilities in circumstances that are not foreseeable. The better approach is to treat the second issue, the refunding issue, as an instance of transaction fraud. The second issue is a scheme, a course of business designed to defraud the investors of the first issue. Rather than a damage action for nondisclosure in the first issue under Rule 10b-5(b), what is called for is that the second issue be enjoined as violative of Rule 10b-5(a) and (c).\textsuperscript{203}

\section*{§ 8:4.2 The TSC Standard}

The materiality requirement in Rule 10b-5(b) has generally been defined by reference to the Supreme Court’s interpretation of similar language in Rule 14a-9 regulating proxy information,\textsuperscript{204} and in 1988, the Supreme Court specifically endorsed the application of the same


\textsuperscript{204} Rule 14a-9, adopted by the Commission pursuant to § 14 of the 1934 Act, provides:
test of materiality under both provisions. In *TSC Industries, Inc. v. Northway, Inc.*, the court resolved a conflict in the circuits by adopting the following standard for materiality: “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” This one sentence presented four comparative thoughts. For a fact to be material [1] there must be a “substantial likelihood” (rather than a likelihood) that a [2] “reasonable” (rather than any) investor [3] “would” (rather than might) consider it [4] “important” (rather than interesting) in making a decision. The Court went on to state

[a] No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

[b] The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

17 C.F.R. § 240.14a-9 [1987].

205. Basic, Inc. v. Levinson, 108 S. Ct. 978 [1988]. Prior to Basic, the Supreme Court’s definition of “materiality” in the context of Rule 14a-9 generally had been followed in cases brought under Rule 10b-5. See, e.g., SEC v. MacDonald, 699 F.2d 47, 49 (1st Cir. 1983); Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 647 (3d Cir. 1980).


207. Id. at 449. See also RESTATEMENT [SECOND] OF TORTS § 538[2][a] [1977].

208. The *TSC Industries* case resolved a debate that had raged among the circuit courts concerning whether a material fact is a fact a reasonable investor “might” consider in deciding how to vote or whether it is a fact the investor “would” consider in deciding how to vote. The “might” cases grew out of a statement in a 1970 Supreme Court decision in which Justice Harlan wrote that materiality “embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote.” Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 384 [1970]. For cases applying the “might” standard, see Beatty v. Bright, 318 F. Supp. 169 (S.D. Iowa 1970); Berman v. Thomson, 312 F. Supp. 1031 (N.D. Ill. 1970). Other courts treated Justice Harlan’s statement as dicta that did not bind lower courts and
that a fact is material if it “would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

Definitions of “materiality” often leave the reader with a sense of frustration. The courts define “materiality” in the context of litigation where something has gone wrong and hindsight easily leads to the conclusion (particularly in nondisclosure cases) that if a postulated statement had been made, everyone’s loss would have been avoided. Without the benefit of hindsight, it is said, it is difficult in preparing a disclosure document to foresee future events that are so obvious in litigation. Definitions prior to TSC Industries that spoke of facts that “might have been” significant to someone were particularly troublesome to the preparers of disclosure. The Supreme Court in TSC Industries was concerned that if anything might be considered material in a litigation context, issuers were likely to deluge the investor with every possible meaningless fact. The Court recognized that overdisclosure can be nondisclosure if significant information is suffocated in the insignificant. The issuer’s “fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision making.”

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209. TSC Industries, 426 U.S. at 449. In 1988, the Supreme Court favorably cited the language quoted from TSC Industries and stated: “We now expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context.” Basic, Inc. v. Levinson, 108 S. Ct. 978, 983 [1988].

210. See supra note 51.

211. TSC Industries, 426 U.S. at 448-49. The Supreme Court reiterated this point in Basic when Justice Blackmun summarized TSC Industries, noting that “the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management ‘simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.’” Basic, Inc. v. Levinson, 108 S. Ct. at 983. In Basic, the Court refused to endorse a bright line test of materiality that would have rendered preliminary merger negotiations material when there is an agreement in principle on price and structure. Instead, the Court again imposed a disclosure duty that requires a heightened level of care to assess the circumstances from the viewpoint of investors:

The final justification offered in support of the agreement-in-principle test seems to be directed solely at the comfort of corporate managers. A bright-line rule indeed is easier to follow than a
The preparers of disclosure documents are well advised to interpret *TSC Industries* as promoting quality disclosure rather than lessening the obligation to be attentive in drafting. The Supreme Court, in effect, urges issuers, underwriters, consultants, and lawyers to evaluate the information they have accumulated and to present it to investors in a manner that ensures that reasonable investors will be able to evaluate the elements of a financing that are significant to the investment decision. This may overstate the liability standard by stressing the practical advice to be inferred. The liability standard is that facts be disclosed that have a “substantial likelihood” of assuming “actual significance” in the investment decisions. The practical significance is that to assure the disclosure of such facts, considerable thought should be given to the presentation and clarity of the prospectus or official statement. *TSC Industries* seeks to discourage plaintiffs from bringing frivolous lawsuits while simultaneously promoting conscientious drafting of disclosure documents.

§ 8:4.3 What Is the “Total Mix” of Information?

One way in which the total mix doctrine has been described is that a statement of fact is material if, when added to the total mix of other disclosed information, the proposed statement could affect the investment decision of the reasonable investor. The difficulty of this construction is that, as anyone knows who has drafted an official statement, decisions are made by the working group that certain information is material when the entire working group recognizes that the statement is unlikely to affect an investment decision. Nevertheless, the entire group considers the statement material. A different explanation is that the total mix doctrine requires that, when the defendant makes a statement that is challenged as misleading, the statement is to be evaluated within the context of other available information.\(^{212}\) Total mix was described by the Fifth Circuit:

standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress’ policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over-or under-inclusive. In *TSC Industries* this Court explained: “The determination [of materiality] requires delicate assessments of the inferences a reasonable shareholder” would draw from a given set of facts and the significance of those inferences to him. \ldots

108 S. Ct. at 985.

212. For a comprehensive discussion of the total mix doctrine, see BROWN, THE REGULATION OF CORPORATE DISCLOSURE § 5.03 (2009 ed.).
The test for determining the adequacy of a disclosure focuses on the disclosure as a whole; it is only if a fact is inadequately disclosed in the “total mix” of information available to the potential investor that liability arises. The lens through which we would have to determine the adequacy of any one disclosure, therefore, would necessarily be fixed to the point at which the disclosure was made. Fixed at that point in time, we would have to expand the lens to include all the information which was available to the investor before that point and contract the lens to keep out all the information which came after.  

Robert Bradbury, chairman of Dolphin & Bradbury, argued the applicability of the total mix doctrine in his appeal of an enforcement proceeding brought by the SEC. The SEC alleged that there were material misstatements and omissions in the official statement of Dauphin County General Authority prepared in connection with the Authority’s bonds issued to finance the acquisition of Forum Place, an office building in Harrisburg, Pennsylvania. Dolphin & Bradbury was the underwriter of the bonds. When the bonds were offered in July 1998, the Pennsylvania Department of Transportation (PennDOT) occupied a substantial portion of Forum Place. PennDOT’s lease was scheduled to (and did) expire in November 2001—well before the maturity dates of the bonds, which ranged from 2003 to 2025. PennDOT leased this space as “swing space” because of environmental problems and fire damage to its own building, but planned to move once its building was renovated or replaced.

The official statement contained general cautionary language in boldface: “The office leases are scheduled to expire prior to the maturity of the 1998 bonds; there is no commitment, requirement, or guarantee that the Commonwealth [of Pennsylvania] will renew or

213. Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 211 [5th Cir.], cert. denied, 488 U.S. 926 [1988]. See also In re Tseng Labs, Inc. Sec. Litig., 954 F. Supp. 1024, 1029 [E.D. Pa. 1996], aff’d, 107 F.3d 8 [3d Cir. 1997] (“There can be no liability under the securities laws because of an alleged failure to disclose information that is already available to the public. This is because such information is already part of the ‘total mix.’”).

extend any of the office leases.” The deficiency in the cautionary language was that Bradbury apparently knew the departure of PennDOT would occur. The Court of Appeals for the District of Columbia Circuit denied the petition of Bradbury and his firm for judicial review of the Commission’s order that had held them liable under the antifraud rules of the 1933 and 1934 Acts and MSRB Rule G-17.\footnote{Dolphin & Bradbury Inc. v. SEC, 512 F.3d 634 (D.C. Cir. 2008).}

But substantial evidence supports the Commission’s conclusion that Bradbury’s cautionary statements were so deficient he must have known investors would be misled by the offering documents. The Commission noted the critical distinction between disclosing the risk a future event \textit{might} occur and disclosing actual knowledge the event \textit{will} occur. Bradbury’s cautionary language only disclosed a \textit{risk} that tenants \textit{might} leave Forum Place—not his knowledge that PennDOT \textit{actually planned} to do so in the near future.\footnote{Id. at 7.}

Bradbury’s total mix argument before the administrative law judge was that PennDOT’s anticipated move from Forum Place was publicly available information in Pennsylvania newspapers at the time the official statement was disseminated, and the newspaper articles should have been considered part of the total mix of information that provided specific contextual detail to the general cautionary language in the official statement. The administrative law judge recognized that “\textit{w}hen allegedly undisclosed material information is readily accessible in the public domain, a respondent may not be held liable for failing to disclose it.”\footnote{In re Public Finance Consultants, Inc., Robert D. Fowler, Dolphin & Bradbury, Inc., and Robert J. Bradbury, Initial Decision Rel. No. 274, Admin. Proc. File No. 3-11465, at 42 (Feb. 25, 2005).} However, the administrative law judge rejected the argument “because the publications in question were not widely available outside of central Pennsylvania,”\footnote{Id.} and investors were known to be geographically dispersed outside Pennsylvania.

More importantly, the administrative law judge recognized that when an offering document is being considered, which asks investors to make an investment decision, the total mix is generally confined to the four corners of the document. Other statements by public officials that are simply information and do not ask investors to take action, such as press releases, will be evaluated in the context of all other available information in the public domain. Political speeches by mayors touting the economic viability of their cities are another...
example in which recipients of the information contained in the speech are expected to evaluate the information within the total mix of available information and in light of puffing expected of politicians. The Dolphin & Bradbury administrative law judge found the total mix doctrine to be narrowly confined when evaluating an official statement:

An offering document should be a “four-corner pronouncement” of all the information necessary for an investor to make an informed decision concerning whether or not to purchase a particular security . . . . Investors, including institutional investors, should be able to rely on the assumption that the offering document contains all the information necessary to make an investment decision . . . . [Dean] Pope, the Division’s expert witness, opined that an offering document must provide complete disclosure to any reasonable and intelligent reader, regardless of where the reader lives and with the assumption that the reader has no knowledge of any particular facts and circumstances not disclosed in the offering document.219

Information in the “four corners” is, however, generally broad enough to include material recently made available to investors, such as continuing disclosure.220 Material specifically referenced in a disclosure document may be considered part of the total mix unless the material information is buried in the referenced material so as to be not readily accessible.221 As stated by one court, although shareholders need not be spoon fed, “they should not have to engage in a scavenger hunt to cull necessary information.”222

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219. Id. at 19.
220. See Brown, supra note 170, at 5–26 et seq.
221. See United Paper Workers Int’l Union v. Int’l Paper Co., 985 F.2d 1190 (2d Cir. 1993) (“[E]ven information actually sent to shareholders need not be considered part of the total mix reasonably available to them if ‘the truth’ is ‘buried’ in unrelated discussions . . . .”).
222. Eliasen v. Hamilton, 1987 U.S. Dist. LEXIS 1826 [N.D. Ill. Mar. 9, 1987]. See also In re Dolphin & Bradbury Inc. and Robert J. Bradbury, 1933 Act Rel. No. 8721, 1934 Act Rel. No. 54143 [July 13, 2006] [citing United Paperworkers Int’l v. Int’l Paper Co., 985 F.2d 1190, 1199 (2d Cir. 1993), which found that eight newspaper articles were too “few in number, narrow in focus, and remote in time” to affect materiality analysis; “the mere presence in the media of sporadic news reports . . . should not be considered to be part of the total mix of information” for purpose of assessing materiality of disclosures in proxy statements]; Richmark Capital Corp., 1934 Act Rel. No. 48758, 81 SEC Docket 2205, 2214–15 & n.24 [Nov. 7, 2003] [stating that press release plus brief mentions in April media reports were not part of “total mix” of information reasonably available to investors in July–September time period; citing United Paperworkers], aff’d, 86 F. App’x 744 (5th Cir. 2004).
On appeal from the administrative law judge’s decision to the Commission, Bradbury was able to have the Commission recognize that some news media information may be part of the total mix of a “four corners” official statement, but the Commission found that the information cited by Bradbury was not “reasonably available”:

The extent to which information is publicly available can be a factor in assessing materiality because, in determining whether an omission is material, we consider whether disclosure of the omitted fact would be viewed by a reasonable investor as having significantly altered the “total mix” of information available. The “total mix” of information may include “information already in the public domain and facts known or reasonably available to shareholders.” The information, however, must be “reasonably” available. Publication of a few articles in local newspapers with limited circulation and discussion at DCGA meetings that were open to the public do not meet this standard. Moreover, although Respondents argue that the entities that purchased the bonds were “large Wall Street institutions that employed sophisticated analysts responsible for researching potential bond purchases,” this was a public offering, and our inquiry is based on the total mix of information that was reasonably available to investors generally.

§ 8:5 Sciento

§ 8:5.1 Required Mental State for Sciento

For a misrepresentation to be characterized as a fraud, the common law has required a showing that the defendant knew the falsity of the statement. That requirement is commonly referred to as the requirement of scienter.223 Sciento refers solely to the maker’s knowledge of the untrue character of the representation.224 The intent or expectation of influencing the conduct of others is a separate element of deceit that is used to define the persons to whom the defendant is liable.225

224. The proposed Federal Securities Code emphasizes the distinction between sciento and misrepresentation. See ALI FEDERAL SECURITIES CODE § 1602 comment [2] (1980). Misrepresentation is the untrue statement of a material fact or the omission of a material fact. Sciento exists if the maker of the misrepresentation knows it is a misrepresentation.
225. Section 531 of the Restatement (Second) of Torts provides:
   General Rule. One who makes a fraudulent misrepresentation is subject to liability to the persons or class of persons whom he intends or has reason to expect to act or to refrain from action in reliance upon the misrepresentation, for pecuniary loss suffered by
Scienter is therefore treated separately from the material misstatement or omission—the misrepresentation—and from the intention of influencing another’s conduct. Scienter must also be distinguished from motive. A person may have good intentions, but that has no bearing on knowledge of the falsity of a statement. If a person represents to another that someone is creditworthy and should be given a loan, the person making the statement may sincerely hope the borrower repays the loan with no loss to the lender, but if the maker of the statement knows the borrower has failed to repay loans in the past, the element of scienter is satisfied. Knowledge and motive are easily confused, since knowledge as an element of fraud is frequently stated as “intent to deceive.” Intent to deceive is not necessarily intent to harm. Rather, it is the knowledge of the falsity of a statement, the knowledge that the defendant does not know whether the statement is true or false, or the knowledge that the defendant has no basis for the making of the representation. The latter two forms of intent to deceive are referred to as “recklessness.”

Prior to the Supreme Court’s decision in Hochfelder, federal courts reasoned from common law concepts, legislative intent, and the overall policies of the securities laws and arrived at differing conclusions as to the degree of culpability required in actions under Rule 10b-5. Some courts accepted a negligence standard. The appellate court’s decision in Hochfelder reversed by the Supreme Court on appeal, demonstrates how courts had wandered from the scienter requirements. Ernst & Ernst had been the auditor for First Securities, a small brokerage firm whose president, Nay, had induced customers to open “escrow” accounts. Nay had converted the escrow accounts to his personal use. Customers deposited checks payable to them through their justifiable reliance in the type of transaction in which he intends or has reason to expect their conduct to be influenced.

Restatement (Second) of Torts § 531 (1977).


229. Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).
Nay or his designee into the escrow accounts. Nay enforced a “mail rule” whereby only he was permitted to open the firm’s mail. When the firm folded and the escrow accounts proved to be nonexistent, the investors brought an action under Rule 10b-5 against Ernst & Ernst for aiding and abetting a fraud in connection with the purchase of securities. The investors argued on the basis of a negligence theory that a proper audit would have uncovered the mail rule and led to the discovery of the scheme to defraud. The Seventh Circuit reasoned that Ernst & Ernst acquired a common law duty of inquiry and disclosure by contracting to audit First Securities and that this duty was translated into a statutory duty to the investors resulting in liability.

Writing for the majority of the Supreme Court, Justice Powell focused attention on the statutes and not, as an initial matter, on the common law: “In addressing this question, we turn first to the language of section 10(b), for ‘[t]he starting point in every case involving construction of a statute is the language itself.’” The statutory language refers to “manipulative” or “deceptive” “devices” and “contrivances.” Each of these terms implies conduct quite different from negligence. Justice Powell wrote that “[u]se of the word ‘manipulative’ is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”

Justice Powell noted the interrelatedness of various statutory provisions. In each instance where there are express civil liability provisions in favor of purchasers or sellers of securities, the provisions clearly specify whether recovery is to be based on knowing or intentional conduct, negligence, or entirely innocent mistake. Where negligence is the standard, plaintiffs are required to meet significant procedural restrictions that do not exist under section 10(b). Justice Powell reasoned that to allow a negligence standard under section 10(b) would nullify the procedural restrictions in the express remedy sections, since actions could be brought under section 10(b) that would not pass the express procedural restrictions of the other sections.

Justice Powell stated in a footnote that “[i]n this opinion the term ‘scienter’ refers to a mental state embracing intent to deceive, manipulate or defraud.” This emphasis on “mental state” is understandable as an effort to distinguish the standard from negligence, but it is at least slightly at variance with the common law emphasis in Derry v. Peek on knowledge of the falsity of a misrepresentation. Hochfelder

231. Id. at 199.
232. Id. at 194 n.12.
seems to introduce the idea of “motive,” and thus appears to set a higher level of culpability than that established for deceit under common law.

In the same footnote, Justice Powell left open the issue of whether recklessness suffices for securities law scienter: “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 section 10(b) and Rule 10b-5.”

Following Hochfelder, the lower courts generally have held that recklessness is actionable, but they have used definitions of recklessness that incorporate the mental state viewpoint expressed in Hochfelder rather than the common law formula, which refers to whether or not the defendant knew the statement was true or false or had any basis for determining whether it was true. The common law reference to “knowledge” can be compared with the definition of recklessness in the context of omissions in Franke v. Midwestern Oklahoma Development Authority:

[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

After Hochfelder, virtually every circuit to consider the issue held that recklessness could amount to scienter under section 10(b) and Rule 10b-5. It takes only a little reflection to realize the necessity of this result. Assume, a few minutes before closing, an official of the issuer states to bond counsel, “I have just received information that indicates there may be a serious problem with the arbitrage certificate.” The bond counsel replies, “Don’t tell me. I don’t want to hear about it. We have a closing to finish.” By refusing to hear the bad news,

233. Id.
234. Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 [7th Cir.], cert. denied, 434 U.S. 875 [1977] (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 [W.D. Okla. 1976], vacated, Cronin v. Midwestern Okla. Dev. Auth., 619 F.2d 856 [10th Cir. 1980] (summary judgment order vacated to permit additional time for discovery and development of evidence)); see also Hackbart v. Holmes, 675 F.2d 1114, 1118 [10th Cir. 1982] (stating that “[f]or purposes of applying Rule 10b-5, the best definition of reckless behavior is conduct that is ‘an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.’” [citation omitted]).
the bond counsel can later claim a lack of actual knowledge that a court had issued an injunction preventing the construction of the project being financed, making it unlikely the project would ever be constructed. If actual knowledge were the sole basis for scienter, the bond counsel could avoid liability. The bond counsel’s behavior, however, was an “extreme departure from the standards of ordinary care.” The bond counsel was reckless in not knowing the information. To cover this circumstance, the formulation of recklessness typified by the Sixth Circuit is important. After the “extreme departure” sentence, the second sentence adds: “While the danger need not be known, it must be so obvious that any reasonable man would have known of it.” 235 “Conscious disregard may constitute scienter.” 236 This formulation is better than the summary in Franke quoted above that concludes the danger is either known or so obvious the defendant “must have been aware of it.” While bond counsel was admittedly aware of a red flag, bond counsel could still deny awareness of the danger of the injunction, whereas in the Sixth Circuit formulation,

236. Id. Nevertheless, most courts have adopted the Seventh Circuit’s recklessness standard, set forth in Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977). That standard defined reckless conduct as “a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious the actor must have been aware of it.” Sundstrand was an omission case and its definition of recklessness was taken from Franke v. Midwestern Oklahoma Development, which is quoted in the text, and was another omission case. The Sundstrand court added that under the Franke definition the danger of misleading investors “must be actually known or so obvious that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even ‘white heart/empty head’ good faith.” The Ninth Circuit, while agreeing that recklessness may satisfy the scienter requirement under section 10(b), requires in the wake of the PSLRA a showing of “deliberate recklessness,” or particularly egregious conduct that reflects some degree of conscious or intentional misconduct. See In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970 (9th Cir. 1999). In the Second Circuit, sufficiently reckless behavior is merely one basis from which intent may be inferred, but “[t]his showing of recklessness must be such that it gives rise to a strong inference of fraudulent intent.” 101 F.3d 263, 267 (2d Cir. 1996). See also Aldridge v. A.T. Cross Corp., 284 F.3d 72, 78–84 (1st Cir. 2002); Novak v. Kasaks, 216 F.3d 310–13 (2d Cir. 2000); In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 [3d Cir. 1999]; Abrams v. Baker Hughes Inc., 292 F.3d 424, 430–32 (5th Cir. 2002); Helwig v. Vencor, Inc., 251 F.3d 540, 550–52 (6th Cir. 2001); Lipton v. Pathogenesis Corp., 284 F.3d 1027, 1034–39 (9th Cir. 2002); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1259–63 (10th Cir. 2001); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1283–84 (11th Cir. 1999), rev’d, 252 F.3d 1161 (11th Cir. 2001).
a “reasonable man” would have known of the injunction because a reasonable person would stop the closing to learn the facts.

The SEC’s enforcement proceeding against the investment banking firm Dolphin & Bradbury and Robert Bradbury was described above under the section on materiality, but the three opinions of the administrative law judge,237 the Commission238 and the D.C. Circuit239 are also important for their consideration of scienter in view of the firm and Bradbury’s denying scienter. The relevant omission in the official statement of the Dauphin County General Authority was the planned departure of PennDOT as the primary tenant from Forum Place, the Harrisburg facility financed with the proceeds of the bonds. Unlike the bond counsel in the above illustrations, Bradbury, the underwriter, did not overtly reject any suggestions from another person in the working group that there was a need to disclose material information. Furthermore, when an institutional investor asked for more information about tenant leases and expectations, Bradbury supplied the information, and the official statement contained general language that the leases expired before bonds matured and there was a risk of nonrenewals. The problem was the omission to state PennDOT’s known, actual intention to leave Forum Place within a few years. In that regard, Bradbury claimed that if the more specific information were necessary for adequate disclosure, the lawyers should have required that the official statement meet the legal standard.

The administrative law judge stated that it was not necessary for the Division of Enforcement to show that respondent acted knowingly or intentionally, but that recklessness was sufficient. Several aspects of Bradbury’s conduct indicated he resisted facing up to the necessity to have specific disclosure. The administrative law judge found that Bradbury was reckless in failing to inform underwriter’s counsel, who was drafting the official statement, about PennDOT’s anticipated move to the Keystone Building and the near certainty PennDOT would not renew its lease at Forum Place. Bradbury was reckless in not following up on information from the financial advisor as to the future use of Forum Place, as though he were avoiding details. Bradbury, the underwriter, was reckless in not participating in any substantial working group discussions about the accuracy of the official statement. Bradbury was reckless in not inquiring about the construction of the

239. Dolphin & Bradbury, Inc. v. SEC, 512 F.3d 634 [D.C. Cir. 2008].
new Keystone Building and in closing one day before the former site of the new Keystone building was demolished by implosion, as though he were avoiding the obligation to inquire about the construction schedule. The administrative law judge stated, “I find that Bradbury’s failure to inquire about the construction schedule was deliberate—he simply did not want to know this readily available information.” 240 Deliberate unwillingness to know material information is the hallmark of recklessness.

The Commission affirmed the administrative law judge’s decision, and provided the further analysis:

In challenging the law judge’s finding of scienter, Respondents assert that they did not attempt to restrict the flow of information, but rather helped investors get information by referring them to others involved with the Forum Place transaction and arranging Forum Place tours. Additionally, they assert that Bradbury disclosed PennDOT’s intended move to one investor and would have disclosed it to others if they had asked about it. They further state that Bradbury “did not consciously reject any suggestion from any other member of the finance team to disclose material information” in the OS and that he involved in the transaction family members, friends, and institutions with which Respondents had significant connections.

We do not believe these facts contradict a finding of scienter. The fact that Respondents did not restrict, and even enabled or facilitated, access by specific investors to certain information about the Forum Place transaction does not contradict our finding that they acted recklessly in offering and selling the bonds based on offering documents that failed to disclose a particular, and critical, piece of information. 241

In denying the petition for judicial review, the D.C. Circuit Court of Appeals reiterated several of the indicia of scienter, and also showed the close connection between scienter and the “total mix” of material information. Bradbury was willing to disclose to investors information that the commonwealth government was likely to use Forum Place as “swing space” for state agencies to occupy on a temporary basis while undergoing renovation or new construction. The implication was that regardless of any lack of long-term tenants, there would be adequate demand by swing space users. The court reasoned that “he contends discussing swing space issues with investors obviated the need to


disclose PennDOT’s departure plans. This misconceives an underwriter’s role. As the standard for materiality makes clear, ‘investor[s]’ must have the opportunity to assess the ‘total mix’ of information.” The court did, however, recognize it was difficult to get one’s arms around Bradbury’s conduct. “It certainly would have bolstered the Commission’s scienter finding if Bradbury had ignored explicit warnings from other key players in the bond offering.”

The court found that there was substantial evidence to support the Commission’s finding of scienter, but in the final paragraph of the opinion the court added: “Were we writing on a blank slate, this would be a very close case because the scienter threshold is high. But we need not decide how to sketch the contours of extreme recklessness on a blank slate because Congress has directed us to uphold the Commission’s findings if supported by substantial evidence.”

§ 8:5.2 Pleading a Strong Inference After PSLRA

PSLRA brought about something of a role reversal between the Second and the Ninth Circuits. Prior to PSLRA, the Ninth Circuit liberally allowed notice pleading under the Federal Rules of Civil Procedure, and the Second Circuit required pleading a strong inference, but allowed strong inference to be pleaded by either (1) motive and opportunity, or (2) facts constituting circumstantial evidence of either reckless or conscious behavior. After PSLRA, the Ninth Circuit concluded that the legislative history of the act mandated pleading “deliberate recklessness,” a standard above that of the Second Circuit. By comparison, courts viewed the Second Circuit as liberal, because pleading motive and opportunity was likely to result in cases going to the jury rather than being dismissed at the motion stage. In *Silicon Graphics*, the Ninth Circuit stated that “although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a strong inference of deliberate recklessness . . . .”

243. *Id.* at 14. Section 25(a)(1) of the 1934 Act provides that a person aggrieved by a final order of the Commission may file a petition requesting the order be modified or set aside with the court of appeals of the circuit in which the petitioner resides or the D.C. Court of Appeals. Section 25(a)(4) provides that the “findings of the Commission as to the facts, if supported by substantial evidence, are conclusive.”
244. *See, e.g.*, Time Warner Sec. Litig., 9 F.3d 259 (2d Cir. 1993).
245. *See, e.g.*, Silicon Graphics Sec. Litig., 183 F.3d 970 (9th Cir. 1999).
246. *Id.* at 974.
Other circuits took a middle ground between the Third Circuit’s adoption of Second Circuit pleading in its entirety, including both “strong inference” and “motive and opportunity,” and the Ninth’s Circuit’s rejection of motive and opportunity. For example, the Tenth Circuit decided that “[a]llegations of motive and opportunity, with nothing more, could allow potentially frivolous lawsuits to go forward with only minimal allegations for scienter.” However, the court added that motive and opportunity should be considered as part of the total mix of information presented.

The Second Circuit itself moved to what it described as “a middle ground.” Novak involved allegations that Ann Taylor Stores intentionally issued financial statements that overstated their financial condition by accounting for inventory at inflated values despite knowing the inventory was obsolete and nearly worthless. The allegations focused on out-of-date merchandise that was stored in warehouses but was not marked down to reflect its potential sales price. The opinion focused on the pleading standard for scienter and reviewed the positions of the various circuits. The court found that the Reform Act adopted the Second Circuit’s “strong inference” standard, but added that the district courts “should not employ or rely on magic words such as “motive and opportunity.” The court did not reject motive and opportunity but found that the cases in the Second Circuit suggest a strong inference may arise

where the complaint sufficiently alleges that the defendants: (1) benefited in a concrete and personal way from the purported fraud . . . (2) engaged in deliberately illegal behavior . . . (3) knew facts or had access to information suggesting that their public statements were not accurate . . . or (4) failed to check information that they had a duty to monitor . . .

The Novak opinion illustrated each of these four factors from Second Circuit cases. The first, which is similar to motive and opportunity, was illustrated by referring to corporate insiders who have made material misstatements to the public in order to keep the price artificially high while they sold their own securities at a profit. The second was illustrated by reference to facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness on the part of the defendant, such as trading on the basis of inside

247. 264 F.3d 1245, 1263 (10th Cir. 2001).
248. Id. See also Phillips v. LCI Int’l, Inc., 190 F.3d 609, 620 (4th Cir. 1999).
250. Id. at 311.
251. Id.
252. Id. at 307.
nonpublic material information. The intentional misconduct is easily identified.\textsuperscript{253} The third is the factor most likely to be applied to issuers of municipal securities. The opinion in \textit{Novak} refers to security fraud claims where a plaintiff has specifically alleged the defendants had knowledge of facts or access to information contradicting their public statements.\textsuperscript{254} The fourth factor is likely to be applied to underwriters who have due diligence obligations as described in chapter 7. The court refers to cases in which a plaintiff alleges facts demonstrating that the defendant failed to review or check information that it had a duty to monitor or ignored signs of fraud.\textsuperscript{255}

\textbf{§ 8:5.3 Pleading Competing Inferences After Tellabs}

After the enactment of the PSLRA in 1995, the circuit courts split over pleading strong inference, as described above, and they split over how to weight competing inferences. The First Circuit maintained that PSLRA did not effect a change in the existing practice according to which, on a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure, all inferences are drawn in favor of the plaintiff.\textsuperscript{256} The Ninth Circuit agreed, but concluded that PSLRA required the court to consider all facts in the complaint.\textsuperscript{257} The Tenth Circuit held that PSLRA required all inferences to be considered to meet the requirement of pleading with particularity.\textsuperscript{258} The Sixth Circuit deviated from Rule 12(b)(6) by concluding that plaintiffs are entitled only to the most plausible of competing inferences.\textsuperscript{259} The Supreme Court granted certiorari to resolve the disagreement among the circuits by reviewing a Seventh Circuit opinion that the strong inference standard would be met if the complaint alleged “facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.”\textsuperscript{260} The Supreme Court in \textit{Tellabs, Inc. v. Makor Issues & Rights, Ltd.}\textsuperscript{261} had before it statements by the manufacturer of fiber optics equipment. It was alleged that claims of stable sales were untrue, that

\begin{itemize}
\item \textsuperscript{253} Id. at 308. See discussion of concealment fraud below.
\item \textsuperscript{254} Id. at 308. See discussion of disclosure fraud below.
\item \textsuperscript{255} Id. at 308. The court uses broker-dealer failure to investigate the source of its representations as an illustration.
\item \textsuperscript{256} Aldridge v. A.T. Cross Corp., 284 F.3d 72, 78 (1st Cir. 2002).
\item \textsuperscript{257} Gornpper v. VSX, Inc., 298 F.3d 893 (9th Cir. 2002).
\item \textsuperscript{258} Pirraglia v. Novell, Inc., 339 F.3d 1181 (10th Cir. 2003).
\item \textsuperscript{259} Helwig v. Vencor, Inc., 251 F.3d 540 (6th Cir. 2001) (en banc).
\item \textsuperscript{260} Makor Issues & Rights, Ltd. v. Tellabs, Inc. 437 F.3d 588, 602 (7th Cir. 2006).
\item \textsuperscript{261} Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 127 S. Ct. 2499 (2007).
\end{itemize}
statements that the next generation of a product was available and demand was good were also untrue, and that earnings and revenue projections were exaggerated. Justice Ginsburg, writing for the majority, found that the Seventh Circuit had erred in examining only one side of the argument, the allegations of the plaintiff, to decide whether “a reasonable person could infer that the defendant acted with the required intent.” Justice Ginsburg concluded that the court “must take into account plausible opposing inferences.” The court is to consider the complaint in its entirety and determine whether “all the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.” PSLRA necessarily overrides, in part, Rule 12(b)(6), because of the requirement to “plead with particularity facts that give rise to a ‘strong’—i.e., a powerful or cogent—inference”:

The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts. To determine whether the plaintiff has alleged facts that give rise to the requisite “strong inference” of scienter, a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.262

Justice Ginsburg also distinguished the pleading standard from the required proof at trial:

A plaintiff alleging fraud in a § 10(b) action, we hold today, must plead facts rendering an inference of scienter at least as likely as any plausible opposing inference. At trial, she must then prove her case by a “preponderance of the evidence.” Stated otherwise, she must demonstrate that it is more likely than not that the defendant acted with scienter.263

The majority opinion did not itself determine whether the allegations pleaded warranted a strong inference, but the Supreme Court vacated the judgment of the Seventh Circuit to provide the opportunity for the lower court to reexamine the allegations in light of the comparative construction required by the opinion.264 *Tellabs* gives wide discretion to the district courts to take judicial notice of

262. *Id.* at ____, 127 S. Ct. at 2510.
263. *Id.* at ____, 127 S. Ct. at 2513.
264. On remand from the Supreme Court, the Seventh Circuit again considered the sufficiency of the allegations as to whether a strong inference of scienter had been pleaded under the Supreme Court test. Again the court concluded that the complaint was sufficient. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008).
information in the public domain to consider plausible inferences. The “all facts” test may be a rejection of both the Ninth Circuit’s Silicon Graphics heightened pleading standards\(^{265}\) and the tendency of the Second Circuit to create formulas, with the Supreme Court showing a preference for the balanced, “middle ground” view of other circuits.\(^{266}\)

A few months after the Supreme Court’s decision, the comparative analysis of inferences of scienter required by *Tellabs* was applied in a First Circuit public finance case, *ACA Financial Guaranty Corp., v. Advest, Inc.*\(^{267}\) In 1998, the Massachusetts Industrial Finance Agency issued $1.2 million of bonds to partially refund outstanding debt, and to finance dormitory construction at Bradford College. The college defaulted on its obligation to pay debt service in 2000, ceased operations, and went into bankruptcy. Plaintiffs were a number of bond funds, individual investors, and the bond insurer. ACA, the bond insurer, participated only in state law claims and was not involved in the federal section 10(b) claim. Defendants were the former college president and former vice-president of administration and finance (both had participated in official statement drafting sessions), sixteen members of the college’s board of trustees, and Advest, the underwriter.

The lower court granted a motion to dismiss. On appeal, the plaintiffs claimed the official statement was misleading (1) by avoiding reference to Bradford’s high rate of student attrition; (2) by misrepresenting projected enrollment levels; (3) by falsely stating that the college intended to contribute $1 million of its own funds toward completion of the construction and renovation project; and (4) by including false statements regarding projected financial aid levels for the 1997–98 and 1998–99 academic years. Bradford had operating deficits every year from 1989 to 1997. Boosting enrollment became a critical goal for the college because tuition, room, board, and other student fees constituted the largest source by far of its operating revenues. There were indications in 1997 that Bradford’s fortunes might be on the upswing. In spite of admitting fewer students than

\(^{265}\) Miss. Pub. Employees’ Ret. Sys. v. Boston Scientific Corp., 523 F.3d 75, 89–90 (1st Cir. 2008) (“The district court did not have the benefit of the *Tellabs* opinion, which reversed a higher standard for scienter imposed by the prior law of this circuit. We apply *Tellabs* and that leads us to a different result. While there is support for defendants’ inferences, we think, at this stage, that plaintiff’s inferences are at least equally strong.”).

\(^{266}\) See, e.g., Winer Family Trust v. Queen, 503 F.3d 319 (3d Cir. 2007). The Third Circuit held that “the District Court properly probed documents attached to defendants’ motion to dismiss.” *Id.* at 328. The Third Circuit further held that “[i]n considering competing inferences, courts may find it necessary to probe the documents integral to the complaint.” *Id.* at 329.

in years past, the matriculation rate rose from 25% in 1996 to 34% in 1997, and the number of full-time enrolled students rose sharply in the fall of 1997. Meanwhile, the combined value of Bradford’s endowment and investment portfolio increased 66% between June 1995 and June 1997.

The First Circuit applied the Tellabs competing inferences standard in parallel with its review of the four claims of material misstatements. The court used the drafting of the official statement to find competing inferences regarding the scienter requirement. The court first stated that under the PSLRA, as with any motion to dismiss under Rule 12(b)(6), the court accepts well-pleaded factual allegations in the complaint as true and views all reasonable inferences in the plaintiff’s favor. The court recognized that the Supreme Court had recently “altered the Rule 12(b)(6) standard in a manner which gives it more heft. In order to survive a motion to dismiss, a complaint must allege ‘a plausible entitlement to relief.’” In addition, while under Rule 12(b)(6) all inferences must be drawn in plaintiffs’ favor, inferences of scienter do not survive if they are merely reasonable, as is true when pleadings for other causes of actions are tested by a motion to dismiss under Rule 12(b)(6).268 The court then added the Tellabs requirements that scienter be evaluated by reference to the complaint as a whole, that the inquiry is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, and that competing inferences should be weighed against the plaintiff’s preferred interpretation of facts.

The plaintiffs’ underlying theory of misrepresentation was that the college’s ability to pay the bonds depended upon the school’s meeting its increased enrollment targets, which would substantially increase the size of the student body, and that even if the college could increase its enrollment, this would not improve the college’s financial condition if it gave students more financial aid to reach this result. The court reviewed each of the four allegations in the context of the official statement and found not only that there were no material misrepresentations or omissions, but, more importantly, that the efforts to make disclosure gave rise to inferences favorable to defendants that outweighed the plaintiff’s theory of scienter.269 The court weighed the competing inferences in respect of each of the four allegations, and then summarized as follows:

269. Id. at ___ (citing Greebel v. FTP Software, Inc., 194 F.3d 185–95 (1st Cir. 1999)).
There are several reasons why the plaintiff’s inference of scienter is not at least equally as strong. First, the Official Statement as a whole candidly laid out the sorry financial history of the college and, for most of its estimates and projections as to a happier future, it provided accurate and non-misleading information, as we discussed. The Official Statement fully disclosed that despite the college’s enrollment growth, the college had (a) incurred operating deficits every year since 1989 and (b) done so with a substantial increase in financial aid funded by the college. It was careful to say it could only estimate that for the 1997–1998 academic year, there would be a reduction in financial aid as a proportion of student income, and that it would be a modest four-tenths of a percent. It explained the basis for the estimate. As to the 1998–1999 academic year, the Statement was careful to say that the college’s financial plan “currently” called for a reduction of one and a tenth percentage points in financial aid over its estimate for the prior year. The Official Statement fully disclosed that some 80% of full-time students received Bradford-funded aid. And the Statement said that based on four factors, the college believed it could reach its enrollment goals and “reduc[e] slightly the average amount of financial aid awards . . . from College funds.” Conversely, the Statement said, failure to meet these goals could “adversely affect the College’s ability to reach Financial Equilibrium.”

The obvious lesson is that forthright disclosure after Tellabs can be used to negate scienter, because the court can review the entire official statement to find inferences favorable to defendants. The opposite applies as well. The official statement can be a source of inferences favorable to plaintiffs.

270. The court also recognized that presumptions such as motive and opportunity that are useful in the corporate setting may not be appropriate to nonprofit organizations:

   In addition, the Bradford College defendants have different characteristics than are typical in securities fraud cases, characteristics which make it more difficult to infer a high degree of recklessness or an intent to defraud. They are unlike the paradigmatic securities fraud defendant, who is likely to be a corporate insider standing to profit from the sale of artificially inflated securities. Here, the defendants are Officers and Trustees of a non-profit educational institution. There are no allegations that the proceeds from the Bradford bonds would be spent on anything that would personally enrich any of the Bradford defendants. There is no allegation that they are particularly sophisticated in securities transactions.
§ 8:6  Reliance

§ 8:6.1  Transaction Causation and Loss Causation Distinguished

If A encourages B, a bank officer, to make a loan to C by stating that C promptly repays debt even though A “knows” that C more typically ignores the repayment of debt, A has made a misstatement to B that is fraudulent by reason of A's knowledge of the misstatement. B, however, is aware of C’s reputation and ignores A's statement. Thereafter, B learns that C is the relative of an important customer of B's bank and decides to make the loan. When C fails to repay the loan, B brings an action against A for the fraudulent misrepresentation. The common law courts determined that A would not be liable to B, since B did not rely on the fraudulent misstatement of A.272

Closely connected to “reliance” is the common law requirement of “causation.” Consider a second example: After A makes the fraudulent misstatement to B, B, having no knowledge of C’s creditworthiness, engages in a standard credit investigation of C. The investigation by the bank fails to uncover the circumstances known to A in which C failed to repay debt. B makes the loan to C. At common law, the making of the investigation by B will not necessarily relieve A of liability, but if B relies on the investigation and not the representation of A, the causal link between A's misstatement and the harm done to B is said to be broken.273

271. RESTATEMENT [SECOND] OF TORTS § 526 comment a (1977): “The word ‘fraudulent’ is here used as referring solely to the maker’s knowledge of the untrue character of his representation.”

272. Section 537 of the Restatement [Second] of Torts provides:

General Rule. The recipient of a fraudulent misrepresentation can recover against its maker for pecuniary loss resulting from it if, but only if, [a] he relies on the misrepresentation in acting or refraining from action, and [b] his reliance is justifiable.


273. Section 546 of the Restatement [Second] of Torts provides:

Causation in Fact. The maker of a fraudulent misrepresentation is subject to liability for pecuniary loss suffered by one who justifiably relies upon the truth of the matter misrepresented, if his reliance is a substantial factor in determining the course of conduct that results in his loss.


Section 547 of the Restatement [Second] of Torts provides:

Recipient Relying on His Own Investigation. [1] Except as stated in Subsection [2], the maker of a fraudulent misrepresentation is not liable to another whose decision to engage in the transaction that the representation was intended to induce is not caused by his belief
These illustrations reveal the analytic similarity of reliance and causation. In the second, arguably B did not “rely” on A’s representation, having relied on the bank’s investigation. In the first, one could argue that A’s representation did not “cause” B’s harm, since the decision to make the loan was based on C’s relationship to an important customer of the bank. Despite the apparent fungibility of the two concepts, the common law courts have treated reliance and causation as separate elements for convenience in dealing with the shadings of various fact situations. In securities law cases, reliance is said to involve a determination of whether the representation was a substantial factor in a particular investor’s investment decision while causation involves a determination of whether the harm suffered by the investor “flowed” from the misstatement.

Transaction causation is conceptually identified with the reliance element of a section 10(b) action. It is the reason why an investor decided to make the investment. “But for” the misconduct of the defendant, usually a misstatement of a material fact, the plaintiff would not have made the investment. The investor relied on the misleading statement, and, therefore, the occurrence of the transaction was caused by the misstatement or omission. Loss causation conceptually links the misleading statement to the loss of the investor. The transaction has been caused by the misleading statement, and, as a separate analysis, it must be determined that the economic injury was caused by the misstatement or omission. In the illustration at the beginning of this section, A encourages a bank officer at bank B to make a loan to C by stating that C promptly repays debt even though A knows that C more typically ignores the repayment of debt. B makes

in the truth of the representation but is the result of an independent investigation made by him.

(2) The fact that the recipient of a fraudulent misrepresentation is relying upon his own investigation does not relieve the maker from liability if he by false statements or otherwise intentionally prevents the investigation from being effective.

Id. § 547 (1977).


275. Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 [2d Cir. 1974], cert. denied, 421 U.S. 976 (1975). In Schlick, the majority opinion first made use of a distinction drawn in the literature between “transaction causation” and “loss causation.” Reliance is treated as transaction causation: that the misrepresentation “caused” the plaintiff to engage in the transaction. Loss causation refers to the linkage between the misrepresentation and the economic harm to the plaintiff. The concurring opinion of Judge Frankel recognizes the “scholarly currency” of the terms but argues that they lead to no more clarity than traditional “reliance” and “causation.” Id. at 384.
the loan to C having relied on the material misstatement of A. The loan to C is to finance a cogeneration facility being constructed by C to provide electricity to Company X and steam to Company Y. Company Y goes into bankruptcy and stops payment on the steam supply contract, and when C reduces output while seeking a new purchaser of steam, Company X refuses payment on the electricity output contract due to interruptions in service. C defaults on the loan repayments to B, and B brings a securities fraud action against A under Rule 10b-5. A made material statements to B on which B relied, but the misstatements were not the cause of B’s loss. Materiality and reliance are insufficient to establish loss causation if there is an intervening event that is the proximate cause of the loss.

If an investment decision is induced by misstatements or omissions that are material and that were relied on by the plaintiff, but are not the proximate reason for the loss, recovery under Rule 10b-5 is not permitted. There is liability if there is justifiable reliance on a material misstatement that does result in a loss. Where reliance connects with the loss, there is “loss causation.” A plaintiff is required to allege and prove both reliance and resulting damages, that is, both “transaction loss” and “loss causation” are required.

In this context, the term “transaction causation” is used to describe the requirement that the defendant’s fraud must precipitate the investment decision. . . . On the other hand, “loss causation” refers to a direct causal link between the misstatement and the claimant’s economic loss.

§ 8:6.2 Presumptions of Reliance

The law of fraud developed out of personal, face-to-face interactions like those described in the foregoing illustrations. In the distribution and trading of securities, it is unlikely that B, the investor, will

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278. The causation linkage between reliance and loss was made in the Supreme Court’s decision in Basic, Inc. v. Levinson, 485 U.S. 224 (1988):

   Reliance is an element of a Rule 10b-5 cause of action because it “provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”

   485 U.S. at 243.
279. Wright v. Ernst & Young LLP, 152 F.3d 169, 177 (2d Cir. 1998); Paracor Fin., Inc. v. Gen. Elec. Capital Corp., 96 F.3d 1151, 1157 (9th Cir. 1996).
confront A, the corporate president, in A’s office and be told material misstatements about the company. The fraudulent utterance by A is likely to be far removed from the information supposedly based on it that B receives. Factual situations therefore present difficult issues for determining whether B has relied on the statement of A or if A’s representation was a sufficient cause of the harm to B for A to be liable. If the line of communication from A to B is “efficient,” the impersonal quality of the communication may not disrupt the application of the basic common law fraud analysis. Commentators on the law of securities fraud have found it useful to give attention to empirical research on the efficiency of markets, on “information,” and on the behavior of investors in determining the selection of a portfolio of investments.

In addition to complexities caused by the impersonal context of securities representations, reliance and causation proved troublesome to courts when they began to view the class action as an appropriate procedural device for handling fraud claims in open market transactions. Courts considered individual investors unlikely litigants because of the expense involved, and they saw that the remedial policy behind the securities laws suggested the facilitation of plaintiffs’ claims by class certification. Reliance and causation, however, are terms that refer to the factual relation of the plaintiff to the defendant’s misrepresentation. Where there is more than one plaintiff the factual mix is likely to differ. Class certification, on the other hand, requires common issues. Reliance and causation are therefore at cross-purposes with efforts of the plaintiffs’ bar to promote class actions.

Courts developed several techniques to mitigate the difficulties for plaintiffs faced with an impersonal market and the procedural requirements of class certification. One approach shifted the inquiry away from the plaintiff to the defendant. If the fraud were sufficiently


284. In a class action under Rule 10b-5 for an allegedly misleading prospectus, Judge Davis of the Court of Appeals for the Second Circuit stated:

In fraud or 10b-5 cases decided in recent years, various rules, mechanisms or presumptions have been put forward for mitigating the problem of showing reliance: Split trials for individual proof on reliance . . . , inferring from the materiality of the misstatement that a reasonable investor would have relied; stressing general reliance on a common course of conduct over a period of time, dispensing with or minimizing the need to prove individual reliance in cases of nondisclosure; using the test, in instances of omission, of whether the claimant would have been influenced to act differently, if the undisclosed fact had been made known, than he in fact did.

egregious, reliance virtually could be presumed. The focus of
the inquiry, it was said, should be less on reliance and more on
materiality. A second approach depersonified the plaintiff. The
creation of a hypothetical construct out of the collectivity of plaintiffs
allowed a uniform analysis of reliance-causation. The reliance of the
individual investor on the misstatement is indirect, although reliance
on the construct, the “market,” is direct. The fraud of A runs not to
B directly, but A is committing a fraud on the market, and B relies on
the market.

[A] Material Omissions

Two factual patterns were particularly troublesome for application
of a routine analysis of reliance. In one case, the defendant was not
responsible for any misrepresentations, but simply omitted to reveal
material facts. It is difficult to show an investor relied on a nonstate-
ment. In the second case, the defendant did make material misrepres-
sentations in, for example, an offering document, but the investor
never read the misstatement, and simply invested because the price
of the stock was rising. In the Supreme Court’s 2008 decision in
Stoneridge Investment Partners v. Scientific-Atlanta, the opinion
summarized two rebuttable presumptions of reliance available to
plaintiffs, one for the omission case, and the other for a misstatement
case. First, if there is an omission of a material fact by one with a duty
to disclose, the investor to whom the duty is owed need not provide
specific proof of reliance. Second, under the fraud-on-the-market
theory, reliance is presumed when the statements at issue become
public in an open and developed securities market.

The decision of the Supreme Court in Affiliated Ute Citizens v.
United States illustrates the presumption of reliance by emphasis
on materiality in circumstances of an omission. Members of an Indian
tribe owned shares in a corporation that had a controlling interest in
valuable tribal property. The defendants were employees of a bank that
made a market in the stock. Without disclosure to the Indians, the
defendants purchased shares from the Indians for resale to others at a
substantially higher price. The Court of Appeals for the Tenth Circuit
found no evidence of reliance and therefore no basis for imposing
liability. The Supreme Court reversed, holding that:

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S. Ct. 761 [2008].
Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. 289

Interpretations of Affiliated Ute have ranged from the inference that its holding is restricted to direct face-to-face transactions in which there is a duty comparable to a fiduciary relationship 290 to the inference that its holding eliminates the reliance requirement altogether. 291 The language of the opinion suggests two distinctions.

The first distinction is between misstatements and omissions. If the facts withheld in an omission case are sufficiently material, it may be assumed that the reasonable investor would have considered the facts in the decision to invest. Reliance therefore can be presumed, and it is for the defendant to demonstrate nonreliance. The burden of coming forward with reliance evidence is shifted from the plaintiff to the defendant. 292

The second distinction is between cases under paragraph (b) of Rule 10b-5 and those under paragraphs (a) and (c). A paragraph (b)
action is more closely related to the paradigm common law fraud situation in which A induces B to make a loan to C upon the misrepresentation of C’s creditworthiness. Such cases suggest the common law elements of fraud, including reliance. Paragraphs (a) and (c), however, are broader and encompass “schemes” and “courses of business” conduct that “operate as a fraud or deceit.” Here, the distinction is between misrepresentations and fraudulent schemes rather than between misrepresentations and omissions. The theory of scheme liability was developed to support a cause of action against secondary actors who do not themselves make misleading statements but do engage in conduct that assists the issuer in disseminating false information to the market. The secondary actor enters into a deceptive transaction as part of a scheme with the issuer that causes foreseeable losses in the securities market. Although the secondary actor may not have spoken to the investors, or had a duty to speak, the secondary actor knew that the very purpose of the transaction was to allow the issuer to misrepresent or disguise its financial condition. The conduct of the secondary actor was deceptive, and there was a foreseeable loss; therefore, it was reasoned, reliance could be presumed. The SEC advocated this theory in an amicus brief in 2006: “The reliance requirement is satisfied where a plaintiff relies on a material deception flowing from a defendant’s act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff’s securities transaction.”

The Supreme Court rejected the reasoning of the scheme liability proponents in its 2008 Stoneridge decision. The Court held that, although conduct can be deceptive, if the deceptive statement or act was not relied upon by the investors, the conduct could not be construed as causing the securities transaction because the conduct was too remote for reliance. In addition, the Court found no rebuttable omission presumption of reliance in the case because the defendants, who did not make any statements to the market, did not have a duty to speak, and thus the Affiliated Ute presumption did not apply.

reliance’ of plaintiff.” (quoting St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040, 1049 (8th Cir. 1977), cert. denied, 435 U.S. 925 (1978)). The plaintiffs in Dekro sued the underwriter of tax-exempt bonds that had been issued by three Colorado water and sanitation districts for securities laws violations and fraud after the issuers defaulted on interest payments. Id. at 409. The plaintiffs alleged that the underwriter had failed to disclose material facts about the developer of real estate projects within the districts. Id.

293. SEC amicus curiae brief in Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006).

[B] Misstatements in an Efficient Market

Blackie v. Barrack\textsuperscript{295} presents an example of the use of indirect reliance as a rebuttable presumption. The case was brought as a class action by purchasers of a corporation’s common stock during a twenty-seven month period. The plaintiffs argued that a series of documents released by the corporation contained material misstatements that artificially inflated the price of the corporation’s stock. The opinion stated:

\begin{quote}
[P]roof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market. . . . Proof of reliance is adduced to demonstrate the causal connection between the defendant’s wrongdoing and the plaintiff’s loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant’s conduct and plaintiff’s loss is sufficiently established to make out a prima facie case.\textsuperscript{296}
\end{quote}

The investor relies on the market price and therefore indirectly relies on the accuracy of the corporation’s public documents.\textsuperscript{297} “Indirect” reliance is effectively “direct” if the market is an efficient communicator of information.\textsuperscript{298} The fraud-on-the-market theory is based on the argument, as stated by the Blackie court, that the investor is entitled to rely on “the supposition that the market price

\textsuperscript{295} Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976).
\textsuperscript{296} \textit{Id}. at 906.
\textsuperscript{297} When the connection is too remote to speak logically of indirect reliance, “pure causation” theories are explored. For example, in Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981), \textit{vacated as moot sub nom. Price Waterhouse v. Panzirer}, 459 U.S. 1027 (1982), plaintiff had no knowledge of the market for the stock of a corporation that subsequently went bankrupt, but purchased the stock on the basis of reading a favorable newspaper column. The theory of plaintiff’s action was that the newspaper column would not have been favorable if the corporation’s publicly released information, including the annual report, had been accurate. Despairing of indirect reliance, the court found a causal connection between the annual report and the harm to plaintiff.
\textsuperscript{298} A district court in \textit{In re LTV Sec. Litig.}, 88 F.R.D. 134, 144 (N.D. Tex. 1980) reasoned: “Many investors . . . utilize the very efficiency of the market as the affirmative basis for making securities purchases. These investors rely directly on the market to evaluate information for them rather than making their independent analysis of stocks; any reliance of the market on information is thus reliance by these investors.”
is validly set and that no unsuspected manipulation has artificially inflated the price. . . ."  

299 The efficient market hypothesis that the information released by the corporation is rapidly absorbed by the market and immediately reflected in market price is implicit in this reasoning.  

300 The efficient market hypothesis assesses the speed with which the price of a security responds to announcements of new information. The hypothesis assumes that in a free and actively traded efficient market, stock prices accurately reflect all of the information available about a corporation. Any attempt by the average investor to research available information for the purpose of locating mispriced securities in which to invest is futile, because the price of the security already reflects all available information.  

301 The fraud-on-the-market theory permits an assertion of reliance on a distorted market price and does not require unrealistically that the plaintiff allege that it has independently researched primary information.  

Empirical researchers on investor behavior in an efficient market have argued that rational investors do not analyze all publicly available information. Since all available information is assumed to be reflected in price, the average investor has no incentive to look behind the price in a research expedition into the information determinative of the price.  

302 When efficient and inefficient markets are distinguished, it is easy to infer the qualitative difference between them. In fact, efficiency is highly quantifiable, and degrees of efficiency have been


subjected to quantitative research techniques such as regression analysis.\textsuperscript{303}

The Supreme Court adopted the fraud-on-the-market theory in Basic, Inc. v. Levinson\textsuperscript{304} to permit a presumption of reliance in misrepresentation cases arising from securities traded on public markets. The presumption was allowed in a class action under section 10(b) on the theory that in an open and developed securities market, the prices of corporate securities are determined by publicly available material information regarding the company and its business. The reliance requirement can be satisfied by a showing that the market price was affected by the misstatement (or omission), and the plaintiff’s injury was due to a purchase or sale at the then fraudulently induced market price. Fraud-on-the-market theory can create a presumption for both transaction causation and loss causation, as explained by a district court in the Ninth Circuit:

The fraud on the market theory thus shifts the inquiry from whether an individual investor was fooled to whether the market as a whole was fooled. Hence, the theory not so much eliminates the reliance requirement as subsumes it in the fraud-on-the-market analysis. In the same way, the theory also subsumes the inquiry into materiality, causation and damages. For if a misleading or fraudulent disclosure or omission could have had no effect on the security’s market price, the information cannot have been material. Similarly, if a misstatement or omission had no effect on the market price (because, for example, the market already had the correct information from other sources) then there could be no causation and no damages.\textsuperscript{305}

The proponents of scheme liability attempted to apply fraud-on-the-market theory to make an indirect causal connection between the deceptive conduct of secondary actors and the investment decision of the plaintiff. The argument was that in an efficient market investors rely not only upon the public statements relating to a security, but also upon the underlying transactions those statements reflect. The Supreme Court specifically addressed and rejected this argument in Stoneridge: “Were this concept of reliance to be adopted, the implied

\begin{footnotesize}
\begin{enumerate}
\item[303.] Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549 (1984). A market is more or less efficient depending on (1) the identity of two equilibria in the market, the equilibrium that would theoretically result if everyone knew a quantity of information and the equilibrium that is actually observed, and (2) the speed with which new information is reflected in price. \textit{id.} at 558.
\item[305.] \textit{In re} Verifone Sec. Litig., 784 F. Supp. 1471, 1479 [N.D. Cal.], \textit{aff’d}, 11 F.3d 865 [9th Cir. 1992].
\end{enumerate}
\end{footnotesize}
cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule." The majority opinion in Stoneridge reasoned that the acts of the companies that had contracted relations with Charter Communications (the cable company), "which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not respondents [the contracting manufacturers of set-top cable boxes], that misled the auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did." In a straightforward fraud-on-the-market case, the defendant company disseminates misleading information publicly to the marketplace, and there is a direct effect on the price of the stock. In the Stoneridge case, the defendants engaged in certain transactions with the issuer of securities that gave the issuer the opportunity to disseminate misleading information publicly to the marketplace. The defendants did not themselves make any communication, and the Court found the connection to the securities transactions of plaintiffs too remote to be linked by a presumption based on the efficient market hypothesis.

The SEC’s integrated disclosure system is based on the efficient market hypothesis. For administrative convenience, the SEC has adopted a three-part typology marking a rough division of markets into three categories of efficiency. The integrated disclosure system divides registrants under the 1933 Act into

(1) companies that are widely followed by professional analysts,

(2) companies that have been subject to the periodic reporting system of the 1934 Act for three or more years but are not widely followed, and

(3) companies that have participated in the 1934 Act reporting system for less than three years.

The first category of registrants is permitted to register on Form S-3, which relies on incorporation by reference to 1934 Act periodic reports and thereby minimizes the amount of disclosure required in the prospectus. The reduction of mandatory disclosure to the transactional information and updating "is predicated on the Commission's belief that the market operates efficiently for these companies, that is, that the disclosure in Exchange Act reports and other communications by the registrant, such as press releases, has already been disseminated.

and accounted for by the market place."

Registrants on Form S-2 are entitled to incorporate certain 1934 Act reported information but not to the extent of S-3 registrants, on the theory that the market does not as efficiently reflect information in price for these companies. S-1 registrants are required to disclose all material information in the prospectus. The SEC has summarized the efficient market basis for integrated disclosure as follows:

Proposed Form S-3 recognizes the applicability of the efficient market theory to the registration statement framework with respect to those registrants which usually provide high quality corporate reports, including Exchange Act reports, and whose corporate information is broadly disseminated, because such companies are widely followed by professional analysts and investors in the market place. Because these registrants are widely followed, the disclosure set forth in the prospectus may appropriately be limited, without the loss of investor protection, to information concerning the offering and material facts which have not been disclosed previously. The abbreviated disclosure is made possible by the use of incorporation by reference of the registrant’s Exchange Act information into the prospectus. Because of the abbreviated disclosure, the utility of proposed Form S-3 is limited to widely followed companies.

[C] Misstatements in the Public Finance Market

Most transactions in municipal securities do not engage the mechanisms of an efficient corporate market in which there is sufficiently active trading for the public dissemination of material information to have a direct impact on price. The presumption of reliance that is allowed by courts, in which the fraud-on-the-market theory is applied, assumes that information is transmitted with little or no “cost” to a broad spectrum of participants so that the information is immediately reflected in price. For example, an airport’s ability to meet rate covenants in the trust indenture may be declining over time, or a hospital may be losing key surgeons to a competitor, negatively impacting revenues. In neither case are there market mechanisms


308. Generally, an issuer uses Form S-2 if the registrant but not the transactional requirements of Form S-3 are met. Compare Form S-2, 17 C.F.R. § 239.12 [1987] with Form S-3, 17 C.F.R. § 239.13 [1987]. Issuers for whom no other form is authorized or prescribed use Form S-1. 17 C.F.R. § 239.11 [1987].

comparable to those operative in, for example, the public announce-
ment of a major corporation in response to stock exchange rules to
promptly notify the marketplace of material information. If the airport
or the hospital provides continuing disclosure to investors that con-
tains misleading positive information, but the price of outstanding
municipal securities is unaffected because of inefficient mechanisms
of communication to the market and negligible trading activity, it
will be difficult for a subsequent buyer of the securities who never
read the misleading continuing disclosure to claim reliance on the
price of the securities as a substitute for reliance on the misleading
information.

The difficulty for an investor in municipal securities to convince a
court of a presumption of reliance based on the efficient market
hypothesis is made apparent by an examination of the preconditions
applied by courts to allow plaintiffs the benefit of a fraud-on-the-
market presumption. When analyzing the applicability of the fraud-
on-the-market doctrine, courts have traditionally considered at least
five factors to determine whether a company’s stock is sold in an
efficient market: (1) whether the stock trades at a high weekly volume;
(2) whether securities analysts follow and report on the stock;
(3) whether the stock has market makers and arbitrageurs; (4) whether
the company is eligible to file SEC registration form S-3, rather than
form S-1 or S-2; and (5) whether there are “empirical facts showing a
cause and effect relationship between unexpected corporate events or
financial releases and an immediate response in the stock price.”
These factors are referred to as the “Cammer factors” because they
were articulated by the district court of New Jersey in Cammer v.
Bloom, and a number of courts have cited the Cammer factors.

Clearly, most issues of municipal securities do not have the
characteristics of the Cammer factors, and the fraud-on-the-market
presumption of reliance in public finance is limited. Nevertheless,
there are issues of municipal securities, most notably industrial
development bonds, that are guaranteed by a private corporation.
Additionally, there are financial guarantees of many issues by
commercial banks and insurance companies. The corporate and
financial guarantors may be issued by companies that meet criteria

311. See, e.g., Binder v. Gillespie, 184 F.3d 1059, 1064 [9th Cir. 1999] [using
Cammer five-factor analysis to determine whether market is efficient;
concluding that the mere existence of market makers and arbitrageurs is
insufficient under this test]; Hayes v. Gross, 982 F.2d 104, 107 n.1 [3d Cir.
1992] [adopting Cammer’s “thorough analysis”]; Freeman v. Laventhal &
Horwath, 915 F.2d 193, 199 [6th Cir. 1990] [same]; In re USA Talks.com
2000].

(Fippinger, Rel. #18, 7/09) 8–115
for application of fraud-on-the-market theory, but the misrepresentation would necessarily relate to the guarantor for efficient market theory to apply. If the misrepresentation is related to the underlying securities or any part of the issue other than the guarantors, the theory should not apply because the efficient mechanism of communication would not be operative. Also, the municipal securities may be the equivalent of debentures by the corporation, but the problem remains that the efficient flow of information about the guarantor to the guarantor’s stockholders or debenture holders may not be translated into a comparable efficiency in respect of the holders of municipal securities guaranteed. Even more difficult is the case in which a corporation that would ordinarily be subject to fraud-on-the-market treatment for its own securities is not a guarantor of the entire issue, but guarantees a part of the structure of the financing. For example, a public power authority enters into a take-or-pay contract with a number of customers, including cities and a private utility that is a corporation entitled to file S-3 forms with the SEC and a likely candidate for fraud-on-the-market treatment in its own issues of securities. In this case, information about the company is unlikely to flow through to the investors in the municipal securities by efficient mechanisms that would suggest application of the theory.

[D] The Theory That Fraud Created the Market

The highly complex and diverse public finance structures are capable of analysis by reference to the efficient market hypothesis with corresponding variations in the plaintiff’s obligation to evidence reliance. Consequently, the abandonment of the efficient market hypothesis by the Fifth Circuit in Shores v. Sklar\(^{312}\) was a unique departure from the efficient market hypothesis. The opinion in Shores rejected the quantifiable test of the impact of a misstatement on price and substituted a highly qualitative theory of fraud on the market. The linchpin of the theory was the court’s subjective evaluation that the securities were not “entitled” to be marketed. Under the court’s analysis, if the bonds were entitled to be marketed, proof of reliance would be required; if the bonds were not entitled to be marketed, as the court concluded, the plaintiff was not required to offer evidence of either direct or indirect reliance. If there were no fraud, there would be no market.

The securities in Shores were tax-exempt industrial development bonds issued to finance a plant for the assembling of mobile homes. The bonds were in default shortly after issuance. The complaint alleged misrepresentations in the offering circular about the capability

\(^{312}\) Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) [en banc], cert. denied, 459 U.S. 1102 (1983).
of the company to manufacture mobile homes, complete misstate-
ments of the security supporting the bonds, false financial statements,
and omissions concerning an investigation by the SEC of the under-
writers. Assuming the truth of the allegations, the facts cried out for
relief. The plaintiff, however, stated in his deposition that he had never
read the offering circular, and he offered no evidence that could be
easily translated into a theory of indirect reliance.

The court reasoned that to the extent the plaintiff had pleaded a
misrepresentation or omission case, reliance was a necessary element
in the cause of action. The opinion summarized the common law
elements of deceit as applied to the securities laws and stated that such
elements, including reliance, apply to “the usual 10b-5 misrepresenta-
tion or omission case. . . .”313 The plaintiff alleged misstatements
in the offering circular, including both misrepresentations and
omissions. The court noted, however, that “[a]t the same time, he
[the plaintiff] admitted that he never read or otherwise relied on the
Offering Circular. If the Ute presumption applies to these nondisclo-
sures, [the plaintiff’s] admission rebuts it.”314 The court therefore
determined that plaintiff’s claim under Rule 10b-5(b) was properly
dismissed.

The rejection of plaintiff’s claim for failure to satisfy the reliance
requirement, however, was limited to a cause of action under
Rule 10b-5(b). The court reasoned that Rule 10b-5(a) and (c) had a
broader thrust than testing disclosure statements. Subparagraphs (a)
and (c) refer to schemes and courses of conduct, ideas that are more
extensive in their reach than the subparagraph (b) reference to state-
ments.315 The offering circular was viewed by the court in this context
as merely one part of a larger “fraudulent scheme,” which the court

313.  Id. at 468.
314.  Id.
315.  The court in Shores held that “the securities laws and regulations have a
purpose broader than merely criticizing ever-lengthening, complex pro-
spectuses. They cover deliberate, manipulative schemes to defraud which
can annul not only the purpose of disclosure but also the market’s honest
function.” Id. at 464. The court reasoned that “[t]o the extent that [the
plaintiff] pleaded the usual 10b-5 misrepresentation or omission case, the
district court was correct. Reliance is an essential element of such a cause
of action, though the burden of proving or disproving reliance may shift
depending on the nature of the case.” Id. at 468. The court concluded that
the district court had erred:

in construing the remainder of Bishop’s complaint as narrowly
confined to charges of misrepresentations and omissions in the
Offering Circular that would have defrauded investors who did rely.
It would permit proof that the defendants engaged in an elaborate
scheme to create a bond issue that would appear genuine but was so
lacking in basic requirements that the Bonds would never have been
found “was so pervasive that without it the issuer would not have issued, the dealer could not have dealt in, and the buyer could not have bought the Bonds, because they would not have been offered on the market at any price.”

Thus the court used a fraud-on-the-market theory to establish causation. The Shores theory of fraud on the market, however, bears no resemblance to the Blackie determination that efficient markets transmit information to price with immediate correlative effects. In Shores the court found that the “securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place.”

The court thus divided offerings into two classes: those that are “entitled to be marketed” and those that are not. If the entire issue has no right to be marketed, there is a fraud on the market.

The twenty-two judge en banc panel could have agreed with the district court that as much as the alleged facts suggested a scheme to defraud, the inability of the plaintiff to plead reliance was a failure to state a cause of action under Rule 10b-5. In fact, ten dissenting judges on the panel reached this conclusion twenty-five years before the Supreme Court’s 2008 decision in Stoneridge.

The majority chose instead to rewrite the law of reliance and create a new fraud-on-the-market theory. The court determined that the offering circular was a part of a pervasive scheme and therefore the case was to be reasoned not under Rule 10b-5[b] but rather under Rule 10b-5[a] and [c]. From this the court concluded that proof of reliance was unnecessary, since this was not “the usual 10b-5 misrepresentation or omission case . . . . Reliance is an essential element of such a cause of action . . . .”

After abandoning reliance, the majority employed its fraud-on-the-market theory to show causation. The court adopted the rationale that if the bonds had not been marketed, the plaintiff would not have been approved by the Board nor presented by the underwriters had any one of the participants in the scheme not acted with intent to defraud or in reckless disregard of whether the other defendants were perpetrating a fraud. Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme.

Id. at 468.

316. Id. at 464 n.2.
317. Id. at 471.
harmed, and since the bonds were not “entitled” to be marketed, the sale of the bonds caused the injury. The entire marketplace was defrauded by the sale, and the fraud-on-the-market theory provides a link to the plaintiff. Clearly this reasoning had nothing in common with the cases that rely on quantitative empirical research in economics and finance resulting in the efficient market hypothesis. *Shores v. Sklar* is not an efficient market case but the application of an ambiguous fairness doctrine that is inappropriate in light of the policy of the securities laws not to vouch for the worth of a security.  

The *Shores v. Sklar* fairness doctrine was given its primary application in decisions involving unregistered tax-exempt bonds. Courts may have taken the position that securities subject to registration with the SEC implicitly are “entitled” to be marketed upon the registration statement being declared effective. As the fairness doctrine was applied in more varying contexts during the 1980s, courts and commentators became increasingly concerned with the implications of *Shores v. Sklar*. One approach has been to accept the idea that a plaintiff should be allowed to rely on the integrity of the market to reject worthless securities, but to raise the burden of proof by requiring the plaintiff to come forward with compelling evidence that the bonds were unmarketable but for the defendants’ fraud.  

*Ross v. Bank South, N.A.*, took this approach of requiring plaintiffs objectively to demonstrate the worthlessness of the bonds. The case involved the 1981 financing of a retirement home in a suburb of Birmingham, Alabama, by the issuance of $29,950,000 of

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319. According to one commentator:  

Because the wisdom of the fraud-on-the-market theory depends upon the type of securities market to which it is applied, courts should be more explicit in recognizing that all securities markets are not the same, rather than announce a unitary theory that applies to all. In developed markets, which are apparently efficient, reliance should be presumed from the materiality of the deception. But because it is at best uncertain whether undeveloped markets are efficient, the fraud-on-the-market theory should not be applied to them in any form.


tax-exempt bonds by the Special Care Facilities Financing Authority of the City of Vestavia Hills. The bonds were to be secured by proceeds from the sale of apartment units in the retirement facility, but sales were insufficient and the bonds went into default. Plaintiffs had not read the official statement, which disclosed the complete reliance of the project on sales of apartment units for the repayment of the bonds. Accordingly, the plaintiffs relied on *Shores v. Sklar* to bypass the Rule 10b-5 requirement of reliance.

The Eleventh Circuit reasoned that the *Shores v. Sklar* requirement, that the defendants knowingly conspired to bring securities into the market which were not entitled to be marketed, created a substantial burden on the plaintiffs. Plaintiffs attempted to demonstrate that to provide coverage for the bonds, the apartment unit sale prices were unrealistically high, and the unmarketability of the apartment units rendered the bonds unmarketable. After reviewing the facts, the court concluded the plaintiffs had failed to demonstrate that the defendants knew the apartment units were unmarketable. In fact, the accurate disclosure in the official statement of the market conditions for the apartments, without adverse consequences on the marketing of the bonds, tended to demonstrate the opposite of plaintiffs’ burden. 323

There was a more severe reaction to *Shores v. Sklar* by the Sixth Circuit in a 1990 decision, again involving a retirement center. The city of Florence, Kentucky, had issued $18,230,000 of tax-exempt bonds in 1983 that went into default in 1985. In *Freeman v. Laventhal & Horwath*, 324 the court refused to relieve plaintiffs of the requirement of showing reliance, stating that the fraud-on-the-market exception to

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323. *Id.* at 730–31.


In *Levinson* we adopted the fraud on the market theory and recognized a rebuttable presumption of reliance arising therefrom. We held that there were five elements a plaintiff was required to allege and prove to invoke the fraud on the market presumption of reliance:

“(1) that the defendants made public misrepresentations, (2) that the misrepresentations were material, (3) that the stock was traded on an efficient market, (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the stock, and (5) that the plaintiff traded in the stock between the time the misrepresentations were made and the time the truth was revealed.”

786 F.2d at 750 [citations omitted].

This formulation of the theory was approved by the Supreme Court in *Basic, supra*, 485 U.S. at 248 n.27. 915 F.2d at 197–98.
reliance applied only in circumstances of an efficient market. *Freeman* may go too far, however, in assuming that new issues of public finance are necessarily inefficient:

We turn next to the question of whether a primary market for newly issued tax-exempt municipal bonds is an efficient market. It follows from our preceding analysis that the fraud on the market theory does not raise a presumption of reliance in the instant case if a primary market for newly issued tax-exempt municipal bonds is not efficient. We agree with appellants’ contention, as a matter of law, it is not.\(^\text{325}\)

In *Abell v. Potomac Ins. Co.*,\(^\text{326}\) a developer, Joe Fryar, paid $100,000 to purchase land and a vacant school building in Cheneyville, Louisiana, for the purpose of establishing a home for mentally and emotionally disturbed patients. Fryar determined the project, named “Westside,” required $5 million in construction costs for improvements, and embarked on a proposal for the Town of Cheneyville to issue industrial development bonds secured by medicaid payments from the state. A nationally recognized feasibility consultant hired by Fryar reported that the project was not feasible, and Fryar subsequently retained a real estate appraiser to give a favorable feasibility report. As part of the overall plan, Fryar sold the real estate to a Bermuda corporation for $150,000, and had the Bermuda corporation sell the property back to Westside, the development, for approximately $2.5 million of which $2 million was paid with the proceeds of the industrial development bonds issued by the town. The Bermuda corporation allowed Fryar to pledge the bonds to secure his performance as developer. In addition to construction costs of $5 million and real estate costs of $2 million, the bond issue included approximately $5 million of capitalized interest and future debt service. The official statement description of the project failed to disclose that a nationally recognized consultant refused to give a

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\(^\text{325}\) 915 F.2d 198.

\(^\text{326}\) Abell v. Potomac Ins. Co., 858 F.2d 1104 [5th Cir. 1988].
feasibility report. In addition, the official statement description of the land acquisition with bond proceeds of $2 million failed to disclose Fryar’s offshore sale of the land for $150,000 and failed to disclose that Fryar’s $2 million of developer equity was derived from the Bermuda corporation’s $2 million of bonds, that is, that the equity was capitalized with bond proceeds.

The plaintiffs, unable to show actual reliance, argued that they were entitled to an Affiliated Ute presumption based on the omissions of information in the official statement described above. The Fifth Circuit, however, found that in Affiliated Ute the defendant failed to say anything “about matters whose very existence plaintiffs had no reason to consider.”327 In denying the presumption, the court found:

Here, the bondholders characterize this case as involving primarily omissions. Their claim is that the offering documents represented that Westside was feasible, when it was not; that Fryar was to have $2 million of his own money in the transaction, when he did not; and that the real estate had a value or cost basis to Westside of over $2.4 million, when it did not. Although we have held these statements to have been both false and material, they are distortions, not omissions.

The bondholders have not argued that Fryar failed to disclose facts about which the investors had no inkling, but that Fryar purposely revealed only part of the truth in an effort to mislead potential purchasers.328

If the Affiliated Ute presumption is not available, a plaintiff may attempt a reliance presumption on the basis of a fraud-on-the-market theory, but the Abell court also rejected a presumption of reliance based on a fraud-on-the-market theory. In Abell, the Fifth Circuit held that the “not entitled to be marketed” standard in Shores applies “only where the promoters knew the enterprise was patently worthless.”329 If securities have no value because the enterprise is worthless, investors should be able to rely on the market reflecting the zero value by market forces rejecting the securities altogether. The official statement had material misrepresentations, and a nationally recognized feasibility consultant denied a feasibility report, but plaintiff did not establish that the Westside project was patently worthless. Therefore, unlike its decision in Shores, the Fifth Circuit denied the presumption of reliance.

327. Id. at 1118.
328. Id. at 1119.
329. Id. at 1121.
§ 8.7 Loss Causation

§ 8:7.1 Common Law and PSLRA

Loss causation provides a link between the deceptive conduct in a section 10(b) fraud case and the economic harm suffered by the plaintiff. In tort law language, it establishes the “proximate cause” of the injury. Loss causation is the connection between the deceptive conduct and the injury, while transaction causation, in tort law language, is the “but for” reason that the purchaser or seller decided to engage in the securities transaction. Transaction causation is generally established by facts that show reliance, and it is not the strictest form of tort law “but for” analysis because it is not necessary to prove the transaction would not have occurred but for the deceptive conduct, but only that the securities transaction was materially affected by the deceptive conduct. The PSLRA did not, however, define what constitutes loss causation, and it was not clear whether the phrase “caused the loss” in the statute was intended to imply a stricter interpretation than the Fifth Circuit’s phrase “touches upon the reasons.” The resulting split in the circuit courts, in part, centered on the issue of proof of price inflation as sufficient to establish loss causation. The Eighth and Ninth Circuits held that fraud-on-the-market theory permitted a presumption that if the plaintiff bought stock at an inflated price, it was reasonable to conclude that plaintiffs were harmed by paying too much for the securities. The Second, Third, and Eleventh Circuits required more than price inflation to show that defendant caused the loss. The use of a fraud-on-the-market theory showing that a

330. See, e.g., Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87 (2d Cir. 2001).
333. See, e.g., Gebhardt v. ConAgra Foods, 335 F.3d 824 (8th Cir. 2003).
misrepresentation resulted in an inflated price may be sufficient for transaction correction as a rebuttable presumption of reliance, but something more is required to prove loss causation in these jurisdictions.  

§ 8:7.2 Loss Causation After Dura Pharmaceuticals

In Dura Pharmaceuticals, Inc. v. Broudo, the Supreme Court reversed a Ninth Circuit decision that used fraud-on-the-market theory to find that an inflated price was sufficient because loss causation can be established on the date of plaintiff’s purchase of the securities at the inflated price. The complaint alleged that Dura made false statements about its drug profits and falsely exaggerated the likelihood that the FDA would approve its new spray device for asthma. Subsequently, the company announced its earnings would be lower than expected, principally because drug sales would be lower. The next day, the share price dropped 50%, and when the company announced eight months later that the FDA was not approving the spray device, there was a temporary one-week drop in price followed by a recovery. The district court had dismissed the complaint, holding there was an insufficient allegation of scienter as to the drug profitability claim, and a failure adequately to allege loss causation as to the spray device claim. The Ninth Circuit reversed the loss causation decision, and the Supreme Court reversed the Ninth Circuit.

The Ninth Circuit used a fraud-on-the-market theory, not only for transaction causation, but also to allow pleading a presumption of loss causation. Justice Breyer, writing the majority opinion for the Supreme Court, reasoned that an artificially inflated purchase price might mean there is a link between the misrepresentation and the economic loss in the price of Dura stock, but it does not follow that the economic loss was causally related to the misrepresentation unless the plaintiff pleads facts to make the connection. Simple logic suggests that as the time period increases between the plaintiff’s purchase of securities and the subsequent sale, it is increasingly likely that other factors intervene to affect the price of the securities. The Court also took note of the language of the PSLRA, which requires plaintiff to plead facts to establish that the wrongful conduct caused the loss cannot be satisfied only by showing the price rise. The Court stated that an inflated price may “touch upon” the loss, but after the PSLRA required facts that defendant’s conduct “caused the loss,” mere touching upon is not sufficient. In addition, Justice Breyer reasoned that simply showing an inflated price is at odds with the common law element of proximate

334. See, e.g., Emergent Capital Inv. v. Stonepath Group, 343 F.3d 189 (2d Cir. 2003).
cause that requires a connection to the loss. The opinion did recognize that “Rule 8 of the Rules of Civil Procedure only requires a short plain statement to give fair notice,” but Justice Breyer stated that the plaintiff should, at the pleading stage, give “some indication of the loss and the causal connection that the plaintiff had in mind.”

The Court remanded to the district court to allow the plaintiff to amend the complaint as to the asthma spray device claim. The subsequently amended complaint stated that the misrepresentations inflated the price, and that the stock price dropped following corrective disclosures made on three separate dates. The district court found the amended complaint was thus sufficient at the pleading stage because some indication was given how the misrepresentations caused the loss. For pleading purposes, courts generally apply Rule 8 and do not require Rule 9(b) particularity pleading, but the amount of facts to be pleaded varies among the district courts.336

*Dura* impacts both pleading and the proof of loss causation. The Supreme Court found that the Ninth Circuit’s price inflation theory was insufficient, but it did not lay out what is required other than the inferences to be drawn from the reasoning employed by Justice Breyer in rejecting mere price inflation.337 Nevertheless, the Seventh Circuit in *Ray v. Citigroup Global Markets*338 found that *Dura*, when combined with pre-*Dura* theories, suggests that fraud-on-the-market remains a viable method of establishing loss causation, as well as a materialization-of-risk standard.

[A] Fraud-on-the-Market Theory

Fraud-on-the-market theory is frequently applied to allow a presumption of reliance on the market to absorb information that is reflected in the price of stock. The information reflected in stock prices

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336. *See*, e.g., *In re Omnivision Techs.*, 2005 WL 1867717 (N.D. Cal. July 29, 2005) ("Plaintiffs purchased Omnivision securities at artificially inflated prices and suffered damages when revelation of the true facts causes a decline in the value of their shares" held sufficient); *In re UnumProvident Corp. Sec. Lit.*., 396 F. Supp. 2d 858 (E.D. Tenn. 2005) ("at least some minimal details" to be pleaded "justifying an inference" that the price drop reflected the market's reaction to the corrective statement); Teachers' Ret. Sys. of La. v. Hunter, 477 F.3d 162 (4th Cir. 2007) ("a plaintiff purporting to allege a securities fraud claim must not only prove loss causation . . . but he must also plead it with sufficient specificity to enable the court to evaluate whether the necessary causal link exists.").


includes material misstatements. Thus, when a plaintiff has not directly read or heard the material misrepresentation, but has decided to purchase stock in reliance on the stock price, the plaintiff presumptively has relied on the misrepresentation. Plaintiffs have used fraud-on-the-market, which is a causation theory, to claim that not only a securities transaction can be presumed by fraud-on-the-market theory, but the same premises may be extended to cover loss causation. After Dura, plaintiffs have met stiff resistance if all they offer to prove is that there is price inflation, and that they relied on the integrity of the market to provide a legitimate price.\textsuperscript{339} The argument of plaintiffs is that the fraudulently high stock price was the obvious cause of the amount of loss when the stock price dropped after a corrective statement was made. Dura makes clear that reliance causation does not equate to loss causation, because the inflated price alone measures nothing without a subsequent price, and causation requires that the drop between the date of the misrepresentation and the date of the corrective statement be attributable to the misrepresentation and not to intervening factors. Nevertheless, fraud-on-the-market theory can be used to establish the inflated price, provided that there is sufficient evidence that the subsequent loss was linked to the inflated price when the corrective statement was made. Reliance on the market on the loss side of the measurement is then based on the idea that the market will not respond to the truth until the falsity is revealed by the corrective disclosure, but when the corrective statement is made, there is a measurable negative effect on price.\textsuperscript{340}

\textbf{[B] Materialization-of-Risk Standard}

Proof of loss causation in the circumstances described above typically involves a misrepresentation that causes an inflated price and a subsequent corrective statement that causes a decline in price, allowing a measure of the loss. A different situation involves a misstatement by the defendant that conceals a risk, a condition, or a likely event, and, when the risk, condition, or event occurs, there is a drop in the market price of the stock that forms a basis for measurement of loss. The “materialization,” the happening, of the undisclosed risk, condition, or event is said to cause the loss. The truth rises to the surface.\textsuperscript{341} But, consistently with Dura, there may be circumstances in which the concealed risk, condition, or event is


\textsuperscript{341.} Id.
revealed slowly over time, and if other factors are occurring during the same period that are deflating the price, it may not be possible to isolate the concealment from other negative factors sufficiently to establish loss causation.\textsuperscript{342}

An important variation of the materialization-of-risk standard was reviewed in the Southern District of New York in connection with initial public offerings (IPOs) by a group of investment bankers who allegedly discounted future earnings estimates in order for the companies making an IPO to beat the estimates and inflate the share prices in the aftermarket.\textsuperscript{343} Expected earnings were concealed, and when the companies beat expectations, the share prices were inflated. Subsequently, the companies failed to meet optimistic expectations, and the plaintiffs attempted to prove loss causation by the materialization standard. The court rejected the argument because the subsequent events did not disclose the alleged underlying scheme, and, therefore, the ability to measure damages on the basis of the scheme was not evident.

In 2006, a year after the IPO case, the Southern District of New York considered a securitization case in which plaintiff argued that the banker concealed, or suppressed, the fact that in pooling mortgages for a securitization, the investment banker failed to engage in adequate due diligence.\textsuperscript{344} The same judge who wrote the IPO opinion, Judge Scheindlin, determined that in this case the high delinquencies of mortgage defaults caused the drop in the price of the securities, and the concealed failure to meet underwriting standards was revealed to provide a basis for determining loss causation.\textsuperscript{345}

\textbf{§ 8:8 Disclosure Fraud: The Issuer’s Duty to Provide Disclosure}

The centerpiece of the regulatory scheme established by the securities laws in the 1930s was the registration requirement for distributions of securities set forth in section 5 of the 1933 Act. The requirement of an effective registration statement pursuant to section 5 is complemented with the requirement that a prospectus meets the standards of section 10. Unless a security is exempt, a distribution cannot be made without the issuer complying with the disclosure

\begin{itemize}
  \item \textsuperscript{342} See, e.g., \textit{In re Williams Sec. Litig.}, 2007 WL 2007987 [N.D. Okla. July 6, 2007].
  \item \textsuperscript{343} \textit{In re Initial Pub. Offering Sec. Litig.}, 2005 WL 1162445 [S.D.N.Y. May 13, 2005].
  \item \textsuperscript{344} Teamsters Local 445 v. Bombardier, 2005 WL 218919 [S.D.N.Y. Sept. 6, 2006].
  \item \textsuperscript{345} See also \textit{In re St. Paul Travelers Sec. Litig. II}, 2007 WL 1589524 [D. Minn. June 1, 2007].
\end{itemize}
system of the securities laws. Nondisclosure is not an option. Likewise, companies subject to the reporting requirements of the 1934 Act are obligated to make periodic disclosure on Form 10-K and Form 10-Q. Again, disclosure is not an option, and therefore, because the dominant theme of corporate securities law is mandatory disclosure, the literature generally has not addressed the source of a legal requirement for issuers of exempt securities to prepare a disclosure document at the time an exempt security is being distributed.

The legal issue is focused by considering a state or political subdivision that refuses to prepare an official statement in connection with the distribution of an issue of municipal bonds. Counsel for the issuer takes the position that the issuer has no legal duty to speak and by disclosing nothing, it will be incapable of making a misleading statement. Citing the Supreme Court’s decision in *Chiarella*, the lawyer argues that a person is entitled to remain silent unless there is a legal duty to speak. The lawyer’s reasoning is that the issuer of municipal securities exempt from the registration requirements of the 1933 Act (by reason of section 3(a)(2) of the 1933 Act) has no duty to speak, and by remaining silent avoids the possibility of a misrepresentation.

The starting point in an attempt to find a duty to prepare an official statement is likely to be Rule 10b-5(b) under section 10(b) of the 1934 Act. There are, however, two analytic problems in finding a duty to speak under Rule 10b-5. First, the language of the rule in referencing an omission makes it unlawful to "omit to state a material fact necessary to make the statements made . . . not misleading" (emphasis added). Material omissions under Rule 10b-5 exist by reason of their implications for statements made, but if no statements are made, Rule 10b-5 alone arguably cannot refute complete nondisclosure. Second, the application of Rule 10b-5 is necessarily limited by section 10(b) of the 1934 Act, and section 10(b) speaks of manipulative or deceptive conduct. The Supreme Court has therefore required a showing of deceit in any case brought under Rule 10b-5. It is arguably difficult to establish manipulative or deceptive conduct in the case of an issuer advised by counsel that there is no duty to prepare an official statement.

Section 17(a) of the 1933 Act differs from section 10 of the 1934 Act in that section 17(a)(2) and section 17(a)(3) do not refer to manipulative or deceptive conduct. An issuer that is simply following its

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lawyer’s advice not to prepare a disclosure document may not be acting with deceit, and a Rule 10b-5 action may be foreclosed, but a section 17(a)(2) or (3) enforcement action under the 1933 Act does not require proof of a deceitful mental state of the defendant.\footnote{Aaron v. SEC, 446 U.S. 680 (1980).}

Section 17(a)(2), like Rule 10b-5(b), makes it unlawful to “omit to state a material fact necessary to make the statements made . . . not misleading” \footnote{RESTATEMENT (SECOND) OF TORTS § 550.} (emphasis added), but section 17(a)(3) makes it unlawful for any person in the offer or sale of any security “to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” If an issuer denies a purchaser of its municipal securities material information that would have affected the investor’s decision whether to purchase the securities being distributed, it is arguable that the practice or course of business has a fraudulent effect.

The Restatement of Torts similarly focuses on the effect of the purchaser being prevented from acquiring material information:

One party to a transaction who by concealment or other action intentionally prevents the other from acquiring material information is subject to the same liability to the other, for pecuniary loss as though he had stated the nonexistence of the matter that the other was thus prevented from discovering.\footnote{See also List v. Fashion Park, Inc., 340 F.2d 457 [2d Cir. 1965] [arguing that affirmative misrepresentation is not necessary under the antifraud rules].}

The commentary in the Restatement of Torts uses illustrations in which a seller is intentionally concealing a defect by the nondisclosure, but the Aaron interpretation of section 17(a)(3) focuses on the effect of the conduct on the investor and not the culpable state of mind of the seller.\footnote{See chapter 7, at section 7:3.}

Section 17(a)(3) is therefore a theoretical basis for concluding new issue disclosure is mandatory for states and political subdivisions.

As a practical matter, underwriters of municipal securities, recognizing their responsibilities to investors under the “shingle” theory,\footnote{See chapter 7, at section 7:3.} began widespread preparation of disclosure documents in the early 1970s and continued the tradition of referencing the document as the “official statement” of the issuer, having the document signed by the issuer and otherwise using language in the introduction to indicate it was an issuer’s document. The obligation of the underwriters under the antifraud rules was effectively employed to impose an obligation on issuers. Once the issuers commenced disclosure it was apparent that disclosure of all material facts was necessary in order to make
the statements made not misleading. The *Restatement of Torts* summarizes the requirement as follows:

One party to a transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated. . .

(b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading.353

Rule 15c2-12 originally promulgated by the SEC in 1989354 and amended in 1995355 requires underwriters in a primary offering of municipal securities with an aggregate principal amount of $1 million or more to review an official statement that an issuer of such securities deems final. The rule defines a final official statement as a document prepared by an issuer. Rule 15c2-12 therefore creates a duty for an issuer to prepare an official statement if the municipal securities are to be underwritten by an investment banking firm subject to the rule. The duty to prepare an official statement coupled with the common law rule cited above that partial disclosure will not suffice if it is misleading, results in a requirement that all material information be disclosed. The lawyer for the issuer is therefore not in a position to counsel total nondisclosure.356

§ 8:8.1 Active and Passive Issuers

It is an attribute of public finance that issuers of municipal securities are not necessarily the persons raising capital. Issuers are frequently created by state law to provide tax-exempt financing for private persons who are entitled under the Internal Revenue Code of 1986 to be the beneficiaries of tax-exempt municipal securities. Issuance by a state or local government is necessary for interest on the securities to be exempt from federal income tax. For example, a Health and Educational Facilities Authority may exist by state law as a passive “conduit” to provide tax-exempt financing for non-profit hospitals and universities. The board members of the Authority could reasonably object to the securities law obligation imposed on the Authority to provide disclosure when the source of material

353. *Restatement (Second) of Torts* § 551.
355. Exchange Act Release No. 34,961 (July 3, 1995); see appendix 6C.
356. Disclosure fraud in public finance also refers to the application of the materiality standard and other fraud concepts to statements that are not formal disclosure documents, such as press releases, and to continuing disclosure pursuant to Rule 15c2-12. *See* chapter 6.
information is the hospital or university.\textsuperscript{357} Rule 15c2-12 allows continuing disclosure to be the responsibility of the hospital or university, but the preparation of the official statement is the responsibility of the governmental issuer.\textsuperscript{358}

The premise of Rule 15c2-12 is that the official statement is the issuer’s document. This conclusion is not varied simply by reason of the beneficiary of the capital formation being another person. When materiality standards derived from the antifraud rules are applied to the drafting of an official statement it may be determined that only a minimal amount of disclosure related to the governmental issuer is necessary. Nevertheless, officials of such issuers may rightfully be concerned about the issuer’s exposure to antifraud liability when the officials do not have firsthand knowledge of material information.

The distinction between active and passive issuers is important in reviewing the cease-and-desist proceeding brought by the SEC in 1998 against three California issuers, a financial advisor and a real estate appraiser.\textsuperscript{359} The three governmental issuers subsequently settled with the SEC by consenting to cease-and-desist orders.\textsuperscript{360} The Nevada County Order and the City of Ione Order related to land-based financings under the California Mello-Roos Community Facilities Act of 1982[Mello-Roos Act].\textsuperscript{361} Community facilities districts may

\textsuperscript{357} Rule 15c2-12 defines a “final official statement” to mean a “document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter[s] and that sets forth information concerning the terms of the proposed issue of securities; information, including financial or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts and other persons material to an evaluation of the Offering. . . .”

\textsuperscript{358} Rule 15c2-12 defines an “issuer of municipal securities” to mean “the governmental issuer specified in section 3[a][29] of the [1934] Act and the issuer of any separate security, including a separate security as defined in rule 3b-5[a] under the [1934] Act.” For a discussion whether the hospital or university signing a loan agreement with the governmental issuer is the issuer of a separate security and therefore also an issuer within the meaning of Rule 15c2-12, see chapter 2. Even if the hospital or university is an issuer, the conjunctive word “and” does not permit the governmental issuer to conclude that it is relieved of responsibility for preparing an official statement.


\textsuperscript{360} Securities Act Release Nos. 7535, 7536, and 7537 [May 5, 1998], [the “Nevada County Order,” the “Wasco PFA Order” and the “City of Ione Order” respectively].

\textsuperscript{361} Article I, chapter 2.5, division 2, title 5 of the California Government Code CAL. GOV’T CODE § 53,311, et seq.).
be organized by political subdivisions pursuant to the Mello-Roos Act to finance infrastructure for real estate developments. The municipal securities are not general obligations of the district, and the developer or other landowners are not personally liable for repayment of the debt. Mello-Roos Act bonds are secured by special taxes levied on the property being developed. In the Nevada County Order, the SEC found that Nevada County formed a district to be contiguous with Wildwood Estates, a residential development owned by G. Michael Montross. The SEC further found that Nevada County had no experience with Mello-Roos Act financing and therefore retained a financial advisor, Virginia Horler, a senior vice president of Rauscher Pierce Refsnes, Inc. (Rauscher). The financial advisory contact provided for Rauscher to prepare the preliminary and final official statements and to “review and analyze all data and information which have a bearing on the program . . . including . . . the value of the appraisal, coverage ratios and debt capacity [and] projected special taxes.”

Pursuant to requirements of the Mello-Roos Act and because Mello-Roos Act disclosure has emphasized land values rather than information about the developer, William McKay was retained to appraise the aggregate value of the lots in the development after the infrastructure financing of roads, drainage and water and sewer pipes. The purpose of the appraisal was to establish that the build-out value of the land after the construction of the improvements financed and before any “vertical” construction of homes was at least three times the amount of liens on the land. None of McKay’s appraisals satisfied Nevada County’s guidelines requiring a 4:1 value-to-lien ratio, but Horler advised the county that a 3:1 ratio was the industry standard. McKay’s appraisals ranged from a low of $2.98 million to a high of $38 million depending on the assumptions. Only the highest two appraisals satisfied the 3:1 value ratio. The principal amount of tax-exempt bonds issued was $9.07 million, and $2 million of taxable bonds were contemplated which required, without consideration of other property liens, build-out value appraisals in excess of $33 million to satisfy the 3:1 ratio.

The Nevada County Order made findings that the build-out value stated in the official statement of $35.28 million was overstated by at least $4 million. The SEC also found that McKay’s bid for appraisal services was $4,000, whereas the next highest bidder was $20,000, implying that Nevada County officials were on notice that McKay’s appraisals, as evidenced by their $35 million variance, could not be accepted without diligent inquiry. The Nevada County Order further implied that retaining Rauscher to review the appraisal did not

insulate Nevada County from responsibility for disclosed appraisals when there were red flags that alerted, or should have alerted, Nevada County officials that they could not rely on McKay’s reports. Alternatively, the implication could be that Virginia Horler was an agent of the county, and the county as principal remained responsible for the conduct of its agent. The advantage of a cease-and-desist order is that the SEC writes the order and has the opportunity to signal the municipal securities industry of a coherent theory of its enforcement. The Nevada County Order, however, is lacking in any reasoned analysis that would be useful to the municipal securities industry.\textsuperscript{363}

If the theory of the Nevada County Order is that county officials had knowledge that did not allow them to rely on professional advisors, it is consistent with the Orange County Report.\textsuperscript{364} In the Orange County Report, the SEC argued that, when, for example, a public official has knowledge of facts bringing into question the issuer’s ability to repay its municipal securities, it is reckless for that official to authorize a bond or note issue with its related disclosure to investors without taking steps appropriate under the circumstances to prevent the dissemination of materially false or misleading information regarding those facts.\textsuperscript{365} Applying the Orange County Report to the Nevada County facts, it could be argued that Nevada County officials knew or should have known that Mello-Roos Act appraisers were “selling” their appraisals and should therefore be reviewed critically or, more specifically, that the circumstances of McKay’s report to them had sufficient inconsistencies or red flags to merit critical review before the county approved an official statement containing the appraisal.

Rather than stating a theory consistent with the Orange County Report, however, the Nevada County Order does little more than state a conclusion:

Despite its retention of professional advisers and appraisers, Nevada County, remained legally responsible for any misrepresentations and/or omissions in the Nevada County Official Statement. The Nevada County Board of Supervisors approved the Nevada County Official Statement.\textsuperscript{366}

\textsuperscript{363} For a discussion of the use of cease-and-desist orders to communicate SEC policy, see chapter 13 at section 13:3.2[C].

\textsuperscript{364} See section 13:1.2 for a discussion of the SEC’s § 21[a] report related to the disclosure responsibilities of the individual members of Orange County’s Board of Supervisors in connection with certain issues of Orange County municipal securities.

\textsuperscript{365} Id.

\textsuperscript{366} Nevada County Order, at 7.
Neither the Wasco PFA Order nor the City of Ione Order makes findings of significant facts pursuant to the theory of the Orange County Report that would establish that officials of the governmental issuer could not rely on its professional advisors. Taken together, the three cease-and-desist orders appear to push the enforcement envelope in the direction of issuer responsibility regardless of the level of issuer activity in the financing.

It is useful to compare the three orders to the Orange County Cease-and-Desist Order.\textsuperscript{367} The SEC found that Orange County, also a political subdivision of the State of California, violated section 17(a) of the 1933 Act and Rule 10b-5 under the 1934 Act in connection with the issuance of notes and bonds aggregating $2.1 billion. The SEC found that there were material misstatements or omissions in connection with the Orange County investment pools. The Orange County financings and facts were significantly distinguishable from the financings and facts resulting in enforcement actions against Nevada County, the City of Ione and Wasco PFA. Orange County was itself raising capital; it was not acting as a conduit in the capital formation of real estate developers in order to provide private persons with tax-exempt financing. In addition, the Orange County Cease-and-Desist Order makes findings clearly linking the misconduct to Orange County personnel:

The Treasurer and the Assistant Treasurer acted with a high degree of scienter. They were involved in the day-to-day management of the County Pools and directed the County Pools’ investments. Of all the participants involved, they had the most detailed knowledge of the County Pools’ investment strategy and declining investment results during 1994. . . . The Treasurer and the Assistant Treasurer also participated in Orange County’s budget process by providing estimates of projected interest revenue. . . \textsuperscript{368}

In a continuum between active and inactive issuers, Nevada County, the City of Ione and Wasco PFA stand somewhere between Orange County and the Health and Educational Facilities Authority that raises capital for private hospitals and universities. As an issuer is more passive in the continuum, liability should be increasingly predicated on facts linking the issuer to the fraudulent conduct. In its enforcement action against the City of Syracuse (related to the city’s own capital formation by general obligation bond indebtedness), the

\textsuperscript{367} Exchange Act Release No. 36,760 (Jan. 24, 1996). The Orange County Cease-and Desist Order is described at section 13:1.1 and section 13:3.2[B].

\textsuperscript{368} Orange County Cease-and Desist Order at 34.
SEC found that “City officials. . . acted knowingly or recklessly. . .”\(^{369}\)

In the Maricopa County enforcement action, the financial statements that were misleading were the county’s financial statements, not the financial statements of a person benefiting from the transaction.\(^{370}\)

The Nevada County Order, the Wasco PFA Order, and the City of Ione Order fail to discuss

1. the distinction between the issuer that is raising capital for itself and the issuer that is raising capital for others,
2. the extent to which it is necessary for there to be a connection between the persons responsible for misconduct and the issuer,
3. the circumstances in which the issuer is responsible for the conduct of an appraiser, and
4. the circumstances in which the issuer is responsible for the conduct of its financial advisor.

The California Debt Investment Advisory Commission issued a report\(^{371}\) in 1998 critical of issuers of land-based financings and their advisors. Superimposing the CDIAC Report on the Nevada County Order, the Wasco PFA Order, and the City of Ione Order suggests a theory that the SEC may have initiated its enforcement actions to achieve a result that holds the governmental issuer responsible for issuing high risk municipal securities regardless of the beneficiary of the financing:

Traditional distinctions between public and private finance are becoming blurred. In the sphere of real estate development, most significantly, local agencies have assumed financing responsibilities that twenty years ago were commonly associated with commercial lenders, raising capital needed to finance public infrastructure in these projects through the issuance of Mello-Roos, Marks-Roos, and special assessment bonds. . .

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\(^{370}\) In the Matter of Maricopa County, Exchange Act Release No. 37,779 [Oct. 3, 1996]: “The County, assisted by others, including a financial adviser, prepared and distributed, or caused others to distribute, Official Statements. . .” containing financial information describing the county’s financial condition that had materially worsened between June 30, 1992, the date of the financials, and July and August 1993, the dates of its official statements. See discussion at section 8:4.2.

Land-based securities typically are issued to finance public improvements in new development projects—streets, sewers, schools, parks and the like. Inasmuch as debt service payments depend upon the successful development and sale of real estate, land-based securities pose a degree of risk that is uncharacteristic of municipal securities traditionally.

For many years, California’s robust real estate market masked the credit risk inherent in the land-based sector. But the protracted real estate slump that beset California in the early 1990s, and from which it has only recently emerged, has plunged land-based bond issues into default in record numbers.372

The CDIAC Report also charges that competition among professional advisors, including bond counsel, has resulted in issuers being encouraged to finance projects that have a dubious statutory basis:

The municipal bond market theoretically is self-regulating with respect to the interpretation of the state’s bond laws. One of the three key roles of the bond counsel retained by the issuer is to determine whether the securities being offered are duly authorized under state law. The two other roles of the bond counsel are to opine on whether a securities offering qualifies for tax-exemption under federal and state law and that the issuance is valid. Bond counsel also participates in due diligence efforts to review the disclosure documents prepared for the offering for compliance with the securities laws. Of the three areas of law for which a municipal securities offering is reviewed for compliance by bond counsel—bond law, tax law and securities law—only the bond laws have no governmental agency specifically assigned to enforce them. The tax opinion of bond counsel may be challenged by the IRS or the state Franchise Tax Board. The completeness and accuracy of an issuer’s disclosure documents may be challenged by the SEC or the state Department of Corporations, or even by investors. The bond laws, however, do not assign specific enforcement authority to any state or local agency, and do not authorize civil or criminal penalties for violations of their provisions. Although the California State Bar may review the unethical conduct of its members generally, it has never undertaken a specific review of bond counsel conduct.

The self-regulatory model may have served the municipal market well in the past, but it appears to be inadequate for the aggressive debt issuance practices and competition that characterizes the new

372. CDIAC Report at 8.
municipal market. In the area of land-based securities, the types of development proposals for which a real estate developer may request financing exhibit a broad range of credit characteristics, from well-capitalized projects with low debt levels to highly leveraged projects exhibiting more speculative characteristics. Certain projects may be marginal candidates for public financing on purely financial grounds, for example, because of low value-to-lien ratios, while others may be marginal candidates because of legal uncertainties concerning, for example, the use of bond proceeds for private purposes. There are marginal situations outside the land-based area that also must be noted. In addition, much of the market today consists of lease-backed securities and other instruments which have no specific statutory authorization. These types of securities are being increasingly used to finance new types of borrowing—such as for pension costs and health care premiums—based on new or evolving interpretations of the state’s statutes and constitutional debt limits.

The problem posed by the marginal financing proposals reviewed by the Task Force is that the bond industry professionals were compensated from the proceeds of bond issues, and therefore had a financial interest in finding a way for the marginal deals to go forward. These professionals would not have been paid had they not done deals. Yet the specific issuers, who were much less experienced in these matters, relied on these professionals for advice concerning the feasibility and legality of these proposals. The lack of any oversight or enforcement mechanism for these marginal financing proposals encouraged creative interpretations of the law.373

The CDIAC Report suggests a potential new theory of issuer liability. If a statute requires findings to be made by experts or others as a precondition to the issuance of municipal securities, and the issuer or its agents “shops” for the necessary opinion in order to satisfy the statute, it is arguable whether the statutory requisite has, in fact, been met. The SEC, in turn, could argue that an issue of municipal securities having dubious legal validity requires disclosure to investors of possible flaws in the legal analysis establishing validity. The SEC applied an analogous theory in its Orange County Cease-and-Desist Order to reason that there are circumstances in which the tax analysis behind a bond counsel opinion should be disclosed. While this view of the SEC is highly controversial, it is equally applicable to the validity portion of bond counsels’ opinion.374

374. For a discussion of the SEC’s views on disclosure of tax analysis in the Orange County Cease-and-Desist Order, see section 13:3.2[B].

(Fippinger, Rel. #18, 7/09)
The Orange County Report was drafted with an implicit recognition that the various legislative bodies in the United States approving issues of municipal securities are not comparable to boards of directors of private corporations with specific statutory responsibilities derived from the 1933 Act. Accordingly, the Orange County Report discusses liability of individual legislators on the basis of their level of involvement in the financing or in the governmental affairs material to disclosure and the red flags that should alert individual legislators to a need for further review before they vote to authorize a financing.375

The SEC appears less willing to openly recognize a sliding scale of issuer liability. The enforcement actions against the City of Syracuse, Maricopa County and Orange County did not provide the occasion for considering levels of liability since each of those issuers was raising capital for itself. In the Nevada County, Wasco PFA, and City of Ione Orders, there was the opportunity to discuss the issue. They were hybrid issuers. There were government purposes to the financings (the provision for infrastructure), but the bonds were not repayable by the governments. The mixed public-private nature of the financings presented a useful opportunity for the SEC to recognize the variation among active and passive issuers, but the SEC appeared to be stuck at the premise that an official statement is the issuer’s document.

§ 8:9 Transaction Fraud: Redemptions and Escrow Restructurings

Transaction fraud is best summarized by a description of Harris v. Union Electric Co.,376 a decision involving a private utility but with a factual situation appropriate for application to public finance. In 1975, Union Electric Company issued $70 million of First Mortgage Bonds bearing interest at 10½% and maturing in 2005. Harris, the class representative, purchased twelve bonds at par for $12,000. In 1978, when the bonds were trading at 113, Union Electric announced a plan to call $50 million of the bonds at par. The market value immediately dropped to 101 or $120 per bond or $1,440 for Harris.

The par call was based on a provision in the mortgage indenture that permitted use of excess moneys in the Maintenance Fund to redeem bonds at par. Although not discussed in the decision, the theory of such provisions is that if anticipated expenditures for the maintenance of a project are not required, the unexpected excess

375. See section 13:1.2.
moneys should be used to reduce debt. The ten-year call protection, with redemption prices commencing at a premium after ten years and declining over several years until prices reach par, is bypassed in the event of unexpected and uncontrollable sources of revenues [such as the receipt of condemnation payments if the project is taken by eminent domain or the receipt of insurance proceeds if the project is destroyed by fire or a similar casualty]. The Union Electric trust indenture provided customary private utility call protection, but it permitted a par call from excess moneys in the Maintenance Fund. When interest rates were lower in 1978, Union Electric devised a plan to issue short-term debt the proceeds of which were deposited into the Maintenance Fund, which under the trust indenture apparently could receive payments from outside sources. Union Electric planned to call its 1975 bonds bearing interest at 10½% at par and repay the short-term debt with a new issue of long-term debt at a significantly lower interest rate. The redemption, therefore, was part of a plan of refunding to achieve a lower interest rate. The plan was challenged as a violation of the contract provisions of the trust indenture in state court, but the court determined that bondholders’ rights had not been violated.377 When the bondholders failed to prevent the redemption as a matter of contract law, they brought a fraud action pursuant to Rule 10b-5.

The redemption provisions, in addition to providing optional call premiums, included a prohibition against calls with moneys borrowed at an interest rate below 10.60%. In short, the trust indenture placed restrictions on refundings to achieve interest rate savings. The language on the cover of the 1975 prospectus, which was expanded upon inside, provided as follows:

The New Bonds are redeemable, at the option of the Company, at the redemption prices set forth herein, provided that, prior to March 1, 1985, the Company may not redeem any of the New Bonds [other than through the Improvement Fund or by the application of certain moneys in the Maintenance Fund or otherwise in the trust estate] from or in anticipation of funds borrowed having an interest cost to the Company of less than 10.60% per annum.378

377. Harris v. Union Elec. Co., 622 S.W.2d 239, 246–50 [Mo. Ct. App. 1981]. However, after the federal courts determined that there was transaction fraud under the 1934 Act, as discussed below, the state court enjoined Union Electric from attempting a redemption as a matter of state law. Harris v. Union Elec. Co., 1988 WL 2570 [Mo. App. 1988] [slip copy].

Union Electric interpreted the call provisions to permit a lower interest rate refunding from amounts in the Improvement or Maintenance Fund,\textsuperscript{379} a result that would preclude refundings at a premium but permit them at par. The court wrote:

A restriction on lower cost refunding at a premium with no such restriction at par affords no meaningful protection against call UE [Union Electric] would never call the bonds at a premium if it could call them at the lower price of par. This renders the premium price list on page twenty-eight of the prospectus meaningless and misleading, since it represents prices that would never be paid. Finally, the prospectus is misleading in that it fails to disclose UE’s right to directly call the bonds through the Maintenance Fund. The bond contract, however, has been judicially construed to provide UE with such a right.\textsuperscript{380}

Significantly, the court separated the contract analysis from the fraud analysis. The right to redeem at par with refunding proceeds is gleaned from the trust indenture. Once the state court affirmed that right, the issue of whether the right was knowingly misrepresented to investors who relied on the misrepresentation, causing them damages, remained as a fraud claim.

In an orderly presentation, the court analyzed the facts in light of each of the elements of a fraud action. Significantly, the case separated in time the application of the “materiality” and “scienter” requirements. The court tested materiality in 1975 when the prospectus was issued, and it tested scienter in 1978 when the refunding plan was conceived. The court did not suggest that Union Electric knowingly misrepresented information with the intent to induce reliance when it mailed the prospectus in 1975. The court made repeated references to testimony that the intention in 1975 was that there be ten-year call protection.

The court determined that the 1975 prospectus contained material omissions in failing to disclose adequately Union Electric’s right to call bonds at par with proceeds of bonds issued below 10.60%. Union Electric then argued that it was free of liability because the material omissions were made without scienter. The court applied the following analysis to bring the 1975 omissions into the 1978 scheme:

\textsuperscript{379} According to this interpretation, Union Electric could not redeem the bonds before March 1, 1985, with funds borrowed at less than 10.60% unless Union Electric did so through the Improvement or Maintenance Funds. \textit{Id.} at 364.

\textsuperscript{380} \textit{Id.}
We also conclude that the evidence is sufficient for the jury to have found that these omissions were part of a larger scheme or course of business to defraud the bondholders. To knowingly implement a plan in 1978 to call bonds that were previously intended and marketed as having solid call protection until 1985, constitutes a course of business, or a device, scheme, or artifice that operates as a fraud on the bondholders in violation of Rule 10b-5(a) and (c). Therefore, UE’s conduct falls within all three subparagraphs of Rule 10b-5.

Although UE officials had no intent to defraud when they represented that the bonds possessed ten-year call protection, they certainly intended to defraud the bondholders of this protection when they announced the plan to call the bonds before the ten-year period had run.\footnote{Id. at 366, 369.}

The court thus linked the two elements of a fraud action. The presumption of reliance in an omission case set forth in \textit{Affiliated Ute} establishes reliance. The causal nexus between Union Electric’s 1978 conduct in devising the plan and the plaintiff’s loss in market value establishes causation.

The additional requirement in Rule 10b-5 that the fraudulent conduct be “in connection with the purchase or sale of any security,” was found to be satisfied as well:

UE’s fraudulent conduct “touches” the class members’ purchases of their bonds. The market price of the bonds reflected the misleading call protection. If the call protection had been accurately disclosed before these members of the class purchased their bonds, they would have paid less for the bonds or demanded a higher yield. Clearly, these members of the class purchased their bonds in connection with UE’s fraudulent conduct.\footnote{Id. at 368.}

The court rejected Union Electric’s argument that damages should be calculated by measuring the difference between a bondholder’s purchase price and the redemption price. Such a calculation would result in negligible damages. Instead, the court reasoned that its responsibility was to “fashion the remedy best-suited to the harm” and concluded that the proper measure of damages was the difference between the market price immediately preceding the redemption announcement ($113$) and the market price immediately after the announcement ($101$).\footnote{Id. at 367.}

\footnotesize
\begin{itemize}
\item \textsuperscript{381} Id. at 366, 369.
\item \textsuperscript{382} Id. at 368. The certified class of plaintiffs in \textit{Harris} included all investors who held bonds on the date of the public announcement of redemption.
\item \textsuperscript{383} Id. at 367.
\end{itemize}
The separation in time of the analysis of scienter and materiality that the court relied upon in *Harris* may be applicable to an escrow restructuring. Consider the following example. A water authority issues $100 million of bonds in 1980 with serial maturities for ten years and a $30 million term maturity in year twenty and a $20 million term maturity in year twenty-five. The bonds have call protection for ten years with declining premiums to par in 1995. The twenty- and twenty-five-year term bonds bear interest at 10% and 10¼%, respectively. In 1988, the water authority issues $60 million of refunding bonds and places the proceeds in escrow with the trustee for the 1980 bonds. The escrow agreement provides that the trustee will pay the principal of the remaining serial bonds and the 1980 term bonds at their maturities together with interest at the times and in the amounts due from amounts on deposit in the escrow fund and from the earnings derived from investments in federal treasury obligations that have been selected to allow timely payments of principal and interest on the 1980 bonds.

The trust indenture authorizing the 1980 bonds provides for the discharge of the lien of the indenture upon deposit with the trustee for the 1980 bonds of an amount which, when invested in defined government obligations, will be sufficient to pay the principal or redemption price of and interest on the 1980 bonds at their maturity dates or at redemption. Loosely referred to as “defeasance,” the discharge of the lien provision allows the revenues of the water authority to be brought under the 1988 indenture to secure the 1988 bonds without the holders of the 1980 bonds retaining any claim to the revenues. The discharge of the lien provision in effect terminates those sections of the indenture that relate to the application of revenues, including the flow of funds provisions and revenue covenants. Unless the indenture language provides for the discharge of covenants rather than the discharge of the lien, the other covenants of the indenture, including the mechanical covenants for dealing with bonds, the timing of deposits with the paying agents, and the replacement of lost or stolen bonds, remain in effect. For example, a covenant to protect the tax-exempt status of the bonds might survive a discharge of lien clause but might be terminated by a discharge of covenants clause depending on bond counsel interpretation. This precise issue is often a subject of law firm drafting history.

The survival of redemption provisions during the escrow period presents a similarly difficult interpretative issue. Redemptions depending on the flow of funds normally will be nullified by a discharge of the lien, since there will no longer be any revenues to enter the flow. An optional redemption from any available source, however, is more problematic. Assume that in 1993 the water authority elects to call $10 million of the 2005 term bonds from unrestricted moneys in the
general fund for the refunding bonds issued in 1988. The call allows a “restructuring” of the escrow fund to permit more favorable investments in government obligations, which will release $11 million to the water authority. In other words, the restructuring results in a $1 million profit to the water authority. The bonds subject to the redemption have a redemption price of 102. The water authority plans to call the bonds in inverse order of maturity and to give notice as required by the 1980 indenture. The water authority takes the position that just as the redemption price and the provisions on the manner of calling survive “defeasance,” so does the water authority’s right to exercise the optional call. In 1993, the 1980 bonds that are outstanding are trading at 110. Immediately after the notice of call, the price of the called bonds drops to 102 and the price of remaining bonds to 103. Both the bondholders whose bonds have been called and the remaining bondholders file lawsuits to have the redemption declared illegal. Alternatively, citing the Harris case, their lawsuits seek damages for transaction fraud from the water authority and the investment bankers who designed the restructuring.

The first consideration for a court reviewing this scenario should be whether the relevant trust indenture permits the redemption. The state court that considered this issue in connection with the Harris facts decided it favorably to Union Electric. Subsequently, a federal district court considered the securities law transaction fraud issue. Applying the analysis of Harris to the escrow restructuring hypothetical, the right to redeem would depend on the language of the “defeasance” section in the 1980 indenture, the remaining covenants of the indenture, the bond itself, and the escrow agreement. For example, the discharge of the lien is often conditioned on the giving of “irrevocable” instructions to the trustee, in which case a restructuring of the escrow or “revocation” of the instructions probably would be impermissible. In some instances, the irrevocable instructions apply only to an escrow for which redemption is contemplated, in whole or part, during the escrow period. Alternatively, the language of the escrow agreement itself might disallow amendment or termination.

As in Harris, the transaction fraud argument must be analyzed in light of the separation of scienter and materiality. Notwithstanding the fact that the water authority had no intention in 1980 of restructuring an escrow in 1993 with an optional call of bonds secured by the escrow fund, the bondholders can be expected to assert that the 1980 indenture contained a material omission because a material omission should be imputed back to the 1980 disclosure document once the plan to restructure is formulated in 1993. They will maintain that in 1993 there is a “knowing” material omission in the relevant disclosure and that the 1993 scienter impregnates the 1980 Official Statement with a material omission. As plaintiffs, they will claim that the water
authority and the investment bankers knew that the market price of
the bonds would have been affected if the ability to call bonds had been
understood by investors. Thus, plaintiffs would argue that the water
authority intentionally had engaged in a course of conduct that had
the effect of a fraud on the investors.

While apparently similar to Harris, the facts in a situation compar-
able to the hypothetical are likely to differ from Harris in an important
respect. The 1980 official statement and the bonds themselves prob-
ably will recite the optional call provisions with the declining pre-
miums without any qualification. The official statement is not likely
to mention that the right to an optional call terminates upon the
discharge of the lien (unless that is to be gleaned from the summary of
the indenture, which would suggest the redemption is illegal). In
Harris, the issuer sought to avoid the optional call provisions in favor
of a suspect special call at par. The hypothetical is arguably the reverse
of Harris with no material misstatement or omission.

Generally, a refunding with the creation of an escrow fund to
maturity is thought of as a fixed, unchangeable structure for which
market prices reflect a triple A rating that is typically assigned upon
the deposit of federal obligations into the escrow fund. In 1987, this
general belief formed the basis for the MSRB to invoke its fair dealing
rule. Although the MSRB lacks jurisdiction over issuers such as the
water authority, both escrow refundings and escrow restructurings
normally are designed by investment bankers who are “municipal
securities dealers” subject to MSRB jurisdiction. When an investment
banker prepares a refunding with the issuer and fails to dispel possible
confusion in the market by not clarifying the status of call provisions,
the investment banker may be violating MSRB Rule G-17, which
requires fair dealing.384 A report from the MSRB noted:

In order to avoid confusion with respect to issues that might be
escrowed-to-maturity in the future, the Board is interpreting rule
G-17, on fair dealing, to require that municipal securities dealers
that assist in the preparation of refunding documents as under-
writers or financial advisors alert issuers of the materiality of
information relating to the callability of escrowed-to-maturity
securities. Accordingly, such dealers must recommend that issuers
clearly state when the refunded securities will be redeemed and
whether the issuer reserves the option to redeem the securities
prior to their maturity.385

384. MSRB Rule G-17 provides: “In the conduct of its municipal securities business,
each broker, dealer, and municipal securities dealer shall deal fairly with all
persons and shall not engage in any deceptive, dishonest, or unfair practice.”
MSRB Rule G-17, MUN. SEC. RUL. BD. MAN. [CCH] ¶ 3581, at 4851.
385. 7 MSRB REP. No. 4, at 1 (Sept. 1987) [footnote omitted].
It remains unclear whether the underwriter of the 1988 water authority refunding bonds is obligated to cause the issuer to restate the rights of the water authority to redeem 1980 bonds secured by the escrow fund in the 1988 official statement if those rights are clearly stated in the 1980 official statement. The disclosure is immaterial to potential investors in the 1988 bonds. The impact of such disclosure on the analysis presented in Harris is uncertain. Under the Harris analysis, the 1980 official statement that was delivered “in connection with” the sale of the 1980 bonds may contain a latent material omission that is not cured by a 1988 document that was not delivered “in connection with” the sale of the 1980 bonds. Perhaps the 1988 disclosure cleanses the 1988 scienter, there being no intent to defraud when there is disclosure.

The implicit variations on a theme in the Harris court's willingness to separate scienter from materiality make one pause. In fact, the reasoning of the Harris court is not without challenge. Union Electric’s plan to redeem bonds from the maintenance fund was the offspring of a similar plan adopted by Florida Power & Light Company. The Florida Power & Light Company initiated a plan of redeeming bonds from amounts held in a “replacement” fund in order to avoid indenture restrictions contained in optional call provisions. As in Harris, litigation ensued. In Lucas v. Florida Power & Light Co., the court first considered the legality of the redemption and then analyzed whether fraud existed. Unlike the Harris court, the Lucas court was unwilling to inject an omission that was based on circumstances that the testimony clearly established were totally unanticipated at the time of disclosure into the materiality test applied to the original disclosure document:

Plaintiffs cannot prove a misrepresentation or omission by asserting failure to disclose a nonexistent intent or to describe remote future contingencies under provisions of FPL's mortgage. FPL did not intend, at the time the bonds were issued, to redeem the bonds at special redemption prices within five years, nor did it intend to refund the bonds. The likelihood at the time of issue that unpredictable circumstances would later lead FPL to decide to

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386. The Harris court stressed that the plan adopted by Florida Power & Light was for a redemption and not a refunding as in Harris. Harris v. Union Elec. Co., 787 F.2d 355, 370 (8th Cir.), cert. denied, 107 S. Ct. 94 (1986). The court also noted that the Florida Power & Light Co. prospectus provided for five-year call protection for lower cost refunding but not for redemptions and that company officials had not intended or represented that the Florida Power & Light Co. bonds would possess protection against calls of any kind for a limited time period. Id.

redeem some or all of the bonds at a special redemption price was remote. . . . The likelihood at the time of issue that FPL would later redeem some or all of the bonds at a special redemption price was unknown and unknowable and, therefore, not a material fact.388

For the Lucas court, materiality is to be tested “in light of the circumstances” at the point in time that the statements are made. Harris ignores the distinction between disclosure fraud under Rule 10b-5(b), which refers to material misstatements or omissions made in light of the circumstances in which they are made, and transaction fraud described as schemes, devices, and courses of conduct in Rule 10b-5[a] and [c]. The basis of a transaction fraud may still be a misstatement, but Rule 10b-5[a] and [c] do not refer to a snapshot of time by use of the phrase “in light of the circumstances in which they were made.” A scheme is fraudulent for the Harris court if it takes advantage of an atmosphere of misinformation.

As a matter of policy, the MSRB fair dealing orientation suggests a useful modification of Harris. The Lucas approach to the hypothetical illustration is to focus on the single point of time of the original disclosure in 1980. The Harris approach is to consider two points of time, 1980 and 1993, relating the 1993 scienter back to an evaluation of the 1980 disclosure. If, as suggested above, it is the atmosphere of misinformation in 1993 that breeds the fraud, then the MSRB requirement that the atmosphere be cleared in 1988 when the refunding occurs makes practical sense. As long as the misinformation is corrected in time for the market to make price adjustments before the plan of redemption is announced in 1993, the defendants should be able to avail themselves of the defense that there is no material omission. The MSRB interpretation of Rule G-17 unfortunately has the consequence of placing the burden of disclosure and a possibility of liability389 on the investment bankers underwriting the 1988 bonds, even though their primary responsibility is to the 1988 bondholders who have little or no interest in the fortunes of the 1980 bondholders.


389. The SEC has authority to impose liability on brokers and dealers, and persons associated with brokers or dealers, who willfully violate the rules of the MSRB. Specifically, § 15(b) of the 1934 Act provides:

The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person
The MSRB approach effectively relieves the investment bankers who are responsible for the plan of escrow restructuring from any responsibility for disclosure. At least the MSRB, the *Harris* court, and the *Lucas* court all agree that liability should not be imposed on the 1980 underwriter.

The practical advice provided by the MSRB in 1987 was further developed in an exchange of letters between the MSRB and the SEC in 1997 and 1998. The MSRB letter addressed developments in primary and secondary market disclosure that suggest alternative means of communicating to the holders of refunded bonds other than the official statement prepared for investors in the refunding associated with such broker or dealer, whether prior or subsequent to becoming so associated—.

[D] has willfully violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

[E] has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph [E] no person shall be deemed to have failed reasonably to supervise any other person, if

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

15 U.S.C. § 78o(b) [emphasis added].

390. 18 MSRB REP. NO. 2, at 45 (Aug. 1998). The letter of inquiry from Christopher Taylor, Executive Director of the MSRB to Richard R. Lindsay, Director of Division of Market Regulation was dated Dec. 23, 1997, and the SEC’s response from Robert L.D. Colby, Deputy Director, Division of Market Regulation to Christopher Taylor was dated May 4, 1998 [1998 Letter].

(Fippinger, Rel. #18, 7/09) 8–147
bonds. The MSRB noted that the SEC’s position in 1988 was that a municipal issuer desiring to reserve its contractual right to exercise optional redemption provisions applicable to the refunded bonds should clearly and conspicuously disclose its intention in any defeasance notice and in the official statement for the refunding bonds. As suggested in the hypothetical above, it is not at all apparent that the holders of the 1980 water authority refunded bonds would have reason to read the official statement delivered in connection with the 1988 water authority refunding bonds.

In its response, the SEC takes note of developments in market efficiency for the transmission of information to holders of municipal securities resulting from MSRB and SEC regulations. MSRB Rule G-36, adopted in 1990 and combined with Rule G-32 in 2009, requires underwriters to file copies of the final official statement with the MSRB, and, if the issue is an advance-refunding, copies of the underlying refunding documents. These documents are made available to the market by the MSRB on EMMA beginning in 2009. Rule 15c2-12 requires underwriters of municipal securities to obtain contractual agreements by issuers of covered municipal securities obligating the issuers to give notice of certain events, if material. Included in the eleven specified events is notice of defeasance of municipal securities. The notice is required to be filed with the MSRB for disclosure on EMMA. In light of these circumstances the SEC’s conclusion in the 1998 Letter applies even more forcibly after the commencement of EMMA in 2009.

These developments have broadened the opportunities for issuers to communicate effectively with the marketplace, with the result that official statements, advance refunding documents, and defeasance notices are now generally accessible.

We believe that the guidance provided in the 1988 Letter as to the disclosure obligations of issuers with respect to the retention of optional redemption provisions in escrowed-to-maturity securities generally remains applicable today. The price and yield of an escrowed-to-maturity security may be significantly altered if, contrary to market expectations, an issuer attempts to exercise optional redemption provisions without having previously disclosed the reservation of its redemption rights. Accordingly, the existence of optional redemption provisions is material to investors, and it would be misleading for an issuer of escrowed-to-maturity securities to reserve optional redemption rights without disclosing this fact.

The question of whether information has been effectively communicated to prospective buyers and the marketplace, and whether adequate disclosure has been made for antifraud purposes, are, of course, dependent upon the facts and circumstances of each particular case. In light of the developments in the municipal securities disclosure system, we believe that, for bonds escrowed to maturity today, issuers should clearly and conspicuously disclose any intent to retain optional redemption rights both in the advance refunding documents and in the defeasance notices filed with the MSRB . . . . Given the increased public availability of the advance refunding documents and defeasance notices, disclosure in the official statement for the refunding bonds has become less crucial, although issuers may wish to continue disclosing the retention of optional redemption rights in this document as well.393

In the course of drafting the 1998 Letter, the Division of Market Regulation expanded on its theoretical basis for concluding that failure to make an adequate disclosure could constitute fraudulent conduct by the issuer of the refunding bonds. In its 1988 Letter the SEC reasoned that any reference to the “prior bonds” in the refunding bond official statement requires clarification of the status of the prior bonds in order for the reference not to be misleading. This characterization was ambiguous as to who was being misled. In the 1998 Letter the SEC more clearly links an omission at the time of refunding to the holders of the refunded bonds:

When an issuer of municipal securities communicates to the public in a fashion that is reasonably expected to reach investors and the trading markets, the information being disclosed is subject to the antifraud provisions. Exch. Act Rel. No. 33741 (Mar. 17, 1994). Depending upon the relevant facts and circumstances, an issuer’s misleading disclosure at the time of the defeasance as to the continued existence of optional redemption rights, combined with a subsequent decision to optionally redeem the prior bonds, may constitute securities fraud. See Harris v. Union Electric Co., 787 F.2d 355 [8th Cir.], cert. denied 479 U.S. 823 (1986). This may be particularly true if the decision to redeem the prior bonds was made after the 1988 Letter and the widespread publicity given to this issue ten years ago.394

The 1998 Letter, in addition, finds the obligation of brokers, dealers and municipal securities dealers to advise holders of refunded bonds,

393. 1998 Letter.
with whom they are engaged in transactions, in MSRB Rules G-17, G-19, and G-30 and in the 1994 amendments to Rule 15c2-12 requiring procedures for making recommendations:

We also believe the guidance provided in the 1988 Letter as to the obligations of dealers with respect to transactions in escrowed-to-maturity securities generally remains applicable today. As noted in the 1988 Letter, the Commission repeatedly has emphasized that a broker-dealer that recommends a security represents that it has conducted a reasonable investigation and has an adequate basis for the recommendation. When a dealer sells a security as “escrowed-to-maturity,” the dealer’s investigation, among other things, should be sufficient to satisfy it that the documents relating to the bond issue support that characterization. In addition, the 1994 amendments to Rule 15c2-12 imposed a requirement that, in general, before a dealer recommends a municipal security, it must have procedures in place that reasonably assure it will receive prompt notice of material event filings (including defeasance notices) with respect to that security. The receipt of these defeasance notices, as well as the increased availability of official statements and advance refunding documents from the MSRB, . . . may assist dealers in satisfying their obligation to conduct a reasonable investigation into the securities they recommend. 395

On March 23, 1977, Florida Power & Light stunned the corporate bond market by announcing it was considering refinancing $63.7 million of 10-1/8% bonds due 3/1/05 at a special redemption price of 101.65. Previously the holders of the $125 million issue believed the issue could not be refunded at an effective interest cost lower that [sic] 10.052% prior to 3/1/80, five years after it was issued, and only then at a call price of 109.76—relatively standard call features for a long-term utility offering.\(^{397}\)

The \textit{Lucas} trial testimony included evidence that even before the Florida Power & Light Co. announcement in March 1977, institutional investors were aware of the risk of a special redemption.\(^ {398}\) The \textit{Lucas} trial court chastised the plaintiffs for failing to investigate the redemption possibilities:

Establishing due diligence on their own part is the plaintiffs’ burden. The plaintiffs offered little, if any, evidence of their own due diligence in making their investment decisions, which respectively involved a reckless disregard for, or deliberate inattention to, the contents of the FPL prospectus, which none of them read or consulted, as well as an apparent and knowledgeable willingness to “gamble” on the part of the more sophisticated investor. . . .\(^ {399}\)

Similarly, the Eleventh Circuit commented in its affirming opinion:

One of FPL’s expert witnesses testified that “we [bond advisors] got zapped through provisions we knew little about.” Outrage and risk-taking, however, do not add up to the elements which must be shown to establish a 10b-5 case.\(^ {400}\)

The conduct of the institutional investors in \textit{Harris} raises the question of what these investors were thinking about for the year after the \textit{Florida Power \& Light Company} announcement and before the \textit{Union Electric Company} announcement. The bonds involved in both \textit{Lucas} and \textit{Harris} were delivered in the same month in 1975 in a market with relatively uniform call provisions.\(^ {401}\) Comparison of the redemption provisions for the two issues reveals striking

\(^{397}\) Lucas v. Fla. Power & Light Co., 765 F.2d 1039, 1042 [11th Cir. 1985] [quoting \textit{Read the Fine Print}, FIN. WORLD] [emphasis in original].


\(^{399}\) 575 F. Supp at 570 [citation omitted].

\(^{400}\) Lucas v. Fla. Power & Light Co., 765 F.2d 1039, 1046 [11th Cir. 1985].

similarities. 402 The Florida Power & Light redemption should have at least raised a “red flag” that would lead the institutional investors in Harris to make inquiry.

The existence of a “red flag” poses several legal issues. The first is whether institutional investors, who are more likely to perceive the danger and have the facilities to make an investigation, should be joined in the same class with ordinary investors. There is an argument that institutional investors are not entitled to plead a fraud-on-the-market theory to avoid bringing forward evidence of reliance, since the fraud-on-the-market theory is premised on the existence of institutional investors as efficient communicators of information that affects the market price. 403 Under this view, a fraud-on-the-market theory belongs in the pleadings of ordinary investors, not institutional investors.

Likewise, the measure of damages for institutional investors may fail to account for the investors’ own risk taking. If institutional investors in utility bonds who were aware of the Florida Power & Light Company plan were willing to accept the risk that Union Electric might attempt a similar plan, and the 113 price of the Union Electric bonds reflected that risk, Union Electric should not be held liable for

402. The cover of the prospectus involved in Lucas provided:

The New Bonds will be redeemable, in whole or in part, upon not less than 30 days’ notice at the general redemption prices and, under certain circumstances, at the special redemption prices as described herein, provided that, prior to Mar. 1, 1980, no redemption may be made at a general redemption price through refunding at an effective interest cost to the Company of less than 10.052% per annum. Such limitation does not, however, apply to redemptions at a special redemption price for the replacement fund or with certain deposited cash or proceeds of released property. The special redemption prices for the New Bonds are 101.67% of the principal amount through Feb. 29, 1976 and decrease thereafter to 100% for the twelve months ending Feb. 28, 2005.

Lucas, 575 F. Supp. at 558.

The cover of the prospectus involved in Harris provided:

The New Bonds are redeemable, at the option of the Company, at the redemption prices set forth herein, provided that, prior to Mar. 1, 1985, the Company may not redeem any of the New Bonds (other than through the Improvement Fund or by the application of certain moneys in the Maintenance Fund or otherwise in the trust estate) from or in anticipation of funds borrowed having an interest cost to the Company of less than 10.60% per annum.


the market’s willingness to gamble. Modern financial theory is capable of dissecting price and isolating the variables that are the components of price. Using these analytic techniques, it may be appropriate to separate the institutional and ordinary investors into separate classes.

The existence of a “red flag” further raises the issue of whether the reliance of the plaintiffs on the ambiguous disclosure language (at least ambiguous after the announcement by Florida Power & Light Co.) was justified. At common law, the action of deceit requires justifiable reliance of the plaintiff on the misrepresentation of the defendant.

As discussed above, the purpose of the reliance requirement in a deceit action is to limit the scope of defendants’ liabilities to the damages caused by the defendants’ misrepresentation. If A represents to B that A’s company is about to strike gold when it is not, and C buys stock in A on the basis of independent analysis and is totally unaware of the misrepresentation to B, C cannot bring an action against A when the stock price falls and C later discovers the misrepresentation to B. C did not rely on the misrepresentation. Reliance protects A from being an insurer for all of the Cs in the investment community by limiting A’s liability to B. The further requirement of justifiable reliance serves a similar limiting function. If the misrepresentation to B that A is about to strike gold is revised to the statement that A is about to strike gold on the moon, the statement becomes sufficiently preposterous to make reliance by B unjustified. The cause of B’s damage is less A’s misstatement than B’s gullibility.

The difficulties in defining “justifiable reliance” are demonstrated by the fact that nine of the twenty-seven sections of the Restatement (Second) of Torts on the law of misrepresentation are devoted to the element of the “justifiability” of the reliance. Prior to Hochfelder,
the federal courts in Rule 10b-5 cases tended to align justifiable reliance with the developing concept of contributory negligence in general tort law. After Hochfelder, courts concluded that it was inappropriate to bar a plaintiff’s action on the grounds of the plaintiff’s own negligent conduct when the plaintiff had to establish intentional or reckless conduct by the defendant. At common law, contributory negligence usually will not preclude recovery for an intentional tort.\(^407\)

The post-Hochfelder decisions have tended to apply a recklessness standard to the plaintiff similar to the recklessness standard applied to the defendant. Inevitably, ideas of plaintiffs’ “due diligence”\(^408\) appear. Just as underwriters’ due diligence takes into consideration a number of contextual factors, the courts have developed factors to be considered in evaluating plaintiffs’ due diligence. The Third, Fifth, and Tenth Circuits have referred to factors including the plaintiff’s access to information, its position in the industry, its sophistication and expertise in the financial community, and its knowledge of the transactional proceedings.\(^409\) The Second Circuit, while avoiding the phrase “due diligence,” has held that sophisticated people “must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information.”\(^410\)

As in the case of underwriters’ due diligence obligation, there must be an extreme departure from ordinary care for the plaintiff to be denied recovery because of its own failure to exercise due diligence. In Dupuy v. Dupuy, the fraudulently low purchase price paid for land in the French Quarter of New Orleans would have been easily discovered by the defrauded, unsophisticated brother with any kind of investigation. However, under the extreme departure standard, the plaintiff’s personal infirmities and lack of opportunity to investigate were

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\(^{407}\) Gabaldon, supra note 396, at 325.


\(^{410}\) Hirsch v. Dupont, 553 F.2d 750, 763 (2d Cir. 1977). But see Mallis v. Bankers Trust Co., 615 F.2d 68, 79 (2d Cir. 1980) (holding “that in . . . light of Ernst & Ernst a plaintiff’s burden is simply to negate recklessness when the defendant puts that in issue, not to establish due care.”) (footnote omitted), cert. denied, 449 U.S. 1123 (1981).
sufficient to allow the plaintiff to recover. On the other hand, an experienced hotel developer probably would be denied recovery for selling land worth a million dollars for $10,000. The court applied the following standard of care in *Dupuy*:

> [T]he question should not be whether [the Plaintiff] acted unreasonably by failing to investigate the condition of [the Defendant]. Instead, the Court should ask whether [the Plaintiff] intentionally refused to investigate “in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow. W. Prosser, section 34 at 185 [1971].”

In determining whether the risk is obvious to the plaintiff, the court should consider the investor’s sophistication in similar transactions, access to information, and the other factors referred to above in connection with plaintiffs’ due diligence.

Assume the following: rather than A informing C that A is about to strike gold on the moon, A confidentially advises C of a strike about to take place in South Africa. C, as tippee, purchases a large block of the company’s stock without advising the seller of the inside information. When the information proves to be false, the price of the stock falls and C incurs an enormous loss. C brings an action against A under Rule 10b-5. In this situation, A’s defense is not that C was unjustified in relying on the misinformation, but that C should not be allowed to recover for a misuse of misinformation. C, it is argued by A, is in pari delicto, a common law defense in a situation of mutual fault. Where the question of justifiable reliance is raised in defense, the issue becomes the quality of care exercised by the plaintiff in self-protection. A defense of in pari delicto is based on defendant’s claim that plaintiff’s conduct has injured third parties and that plaintiff therefore should not be allowed recovery.412

The Supreme Court considered in pari delicto as it applies to securities fraud cases in *Bateman Eichler, Hill Richards, Inc. v. Berner*,413 on facts similar to the illustration in the preceding paragraph. In disallowing the defense, the Supreme Court set forth a two-pronged test:

> a private action for damages in these circumstances may be barred on the grounds of the plaintiff’s own culpability only where [1] as a direct result of his own actions, the plaintiff bears at least

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In the typical insider trading case, the Supreme Court reasoned that the tippee-investor is less blameworthy than the insider who divulged information in violation of a corporate duty. On the second prong, the opinion emphasized the policy objective of exposing unlawful conduct of disclosing inside information. The most effective means of carrying out the policy objective is to "nip in the bud the source of the information" by not discouraging private actions against insiders. "The in pari delicto defense, by denying any incentive to a defrauded tippee to bring suit against his defrauding tipper, would significantly undermine this important goal." 416

Assume that A is an institutional investor who regularly does business with B, a trader for an investment banking firm. A mentions to B that B's firm has been lead manager on a number of refundings in which the escrows have been rated AAA, thereby raising the price in the secondary market. A indicates that it would be very profitable to A if B would advise A of proposed refundings and make available large blocks of bonds in the issues proposed to be refunded. A further states that unless B provides the information, A will do business with another firm. B sells A a large number of bonds expected to be refunded. Instead of the bonds being refunded, a lawsuit is filed against the issuer, and the price of the bonds is driven down in the secondary market. A brings an action against B for fraud, and B raises in pari delicto as a defense. On these facts, it may be that both prongs of Bateman Eichler are satisfied. While B is divulging inside information, the wrongful conduct of A initiates the scheme. The conduct to be "nipped in the bud" is the exercise of economic power to demand a violation of the securities laws.

While justifiable reliance and in pari delicto are separate defenses with distinct histories and applications, Bateman Eichler provides a useful basis for an underwriter to evaluate its ability to avoid liability to a careless institutional investor. While a number of opinions refer to the factors to be considered in connection with the plaintiff's exercise of care to avoid harm, it is unlikely that the plaintiff will be denied relief on the basis of unjustified reliance unless the comparative culpability of the plaintiff and defendant suggests that the plaintiff

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414. Id. at 310–11.
416. Id.
should be denied relief and further that the policy interests behind the federal securities laws are better served by favoring the banker over the investor.

§ 8:10 Concealment Fraud: Insider Trading

Insider trading refers generally to the act of purchasing or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material nonpublic information relating to the security being traded. Corporate officers and directors and other persons having a relationship of trust and confidence with the issuer or its shareholders, as well as persons who misappropriate material nonpublic information, are precluded from trading unless the information is disclosed. Chapter 6, at section 6:3.4, discusses the duty to disclose or abstain in the context of post distribution disclosure obligations, and chapter 1, at section 1:3, introduces the difficult issue whether there are fiduciary duties in debtor-creditor relationships. This section continues the chapter 1 discussion by considering whether the insider trading rules apply to the trading of municipal securities.

Rule 10b-5 applies to "any" person and to "any" security. Likewise, there is nothing in Rule 10b-5(b) that limits material information to "nonpublic" information. However, the implied liabilities developed by the courts have never been as extensive as the literal language of the rule. In 1961, the SEC concluded that the affirmative duty to disclose material information when trading was owed by "insiders," particularly certain officers, directors, and controlling shareholders. The duty arose from access to "inside information" intended to be available for a corporate purpose. By virtue of their position, insiders gain access to nonpublic information, and it would be unfair to allow them to trade on the basis of such information. Two qualitative variables were therefore at play in the development of the rule: the position of the insider and the nature of the information that renders it inside or "nonpublic" information. The treatment of each variable and the relative weight assigned to each variable can lead to striking variety in the insider trading rules.

In Chiarella v. United States, the Supreme Court reversed the conviction of an employee of a financial printer who had gained access to the names of target companies in proof copies of tender offer documents. The Court emphasized the absence of a special relationship of trust and confidence between the printer’s employee and the
corporate shareholders. This approach directs attention to the insider, rather than the inside information, and requires that the insider be a person who has a “fiduciary or other relation of trust and confidence” with the shareholders giving rise to a duty to inform. The Court shifted attention away from access to nonpublic information in the belief that the securities laws are not designed to create a system providing all investors with equal access to information.

By emphasizing a fiduciary duty as the type of relationship that would give rise to a duty to speak, the Chiarella majority has created a presumption in the literature that the insider trading rules do not apply to traders of debt securities, since a number of state courts have held there is no fiduciary duty owed by a corporation to the holders of debt. Fiduciary duties are said to run to the owners of the corporation, the stockholders, but not to the corporation’s creditors.

The presumption of the commentaries may be premature. It is not obvious that Chiarella will be a bar to reaching insider trading in debt. The Court spoke of a special relationship to stockholders, rather than a position within the corporation giving access to information, since the facts before the Court dealt with stockholders, the owners and stand-ins for the corporation itself. Cady, Roberts, which was discussed with approval in Chiarella, defined insiders as persons with a relationship affording access to inside information. If a debt case were before the Court, and the Court used the Cady, Roberts formulation rather than the Chiarella application, the insider trading rules could be applied to debt securities as well as to equity securities.

In the case of junk bonds, which have been the subject of most concern under the Chiarella fiduciary duty standard, precedent exists for extending fiduciary duties from corporations to debtholders when a corporation is on the brink of insolvency. At that point, the

421. Justice Powell, writing for the majority, stated as follows:

We cannot affirm petitioner’s conviction without recognizing a
general duty between all participants in market transactions to
forgo actions based on material, nonpublic information. Formula-
tion of such a broad duty, which departs radically from the estab-
ished doctrine that duty arises from a specific relationship between
two parties . . . should not be undertaken absent some explicit
evidence of congressional intent.

Id. at 234.

422. See, e.g., Levine & Pecaro, Disclosure and Other Issues Involving Fixed
Income Securities, in PRACTISING LAW INSTITUTE, 23RD ANNUAL INSTI-
TUTE ON SECURITIES REGULATION, Vol. II, at 87 (Oct. 31, 1991); Note,

423. See chapter 1, at section 1:3.
debtholders effectively are the corporate owners. 424 If a proprietary 425 relationship is the kind of “special relationship” referred to in Chiarella, junk bonds in many leveraged buyouts, depending on particular facts, may be the functional equivalents of equity ownership.

As to public finance, it is suggested in chapter 1 that a case may be made for giving bondholders protections that are akin to fiduciary duties, a term that itself is malleable. Here it will be noted that the majority opinion in Chiarella did not limit the relationship exclusively to one in which there are fiduciary duties owed under state law. The majority in Chiarella referred to “a fiduciary or other similar relation of trust and confidence between them” 426 as imposing an affirmative duty to speak. In reviewing the facts of a particular financing structure, courts might reasonably conclude that a trust indenture in public finance creates relationships that are distinct from corporate debt relationships. For example, a revenue bond resolution or trust indenture may capture all the revenues of an issuer, subject them to a pledge for the benefit of bondholders, require a flow of revenues through an elaborate system of funds and, in general, create a comprehensive system of financial government. Whether this establishes a “relation of trust and confidence” distinguishable from corporate general obligation debentures within a structure of traditional stock ownership remains to be seen, but Chiarella should not be viewed as an absolute bar to an insider trading case involving municipal securities.

426. 445 U.S. at 226. It should be noted that underwriters have their own relationship of trust and confidence that could form the basis of a Chiarella duty to debtholders independent of the issuer’s duties. See Cady, Roberts, supra note 418. For underwriters’ duties to debtholders generally, see chapter 7, at section 7:3. As to bond traders, it should be noted that where a violation is present, contemporaneous traders were given an express right of action by the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) [codified at 15 U.S.C. § 78t-1 (1988)]. Appearing as § 20A of the 1934 Act, the statute makes no distinction between debt and equity securities:

Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.
The misappropriation theory of the Second Circuit,\textsuperscript{427} an alternative to the \textit{Chiarella} duty-to-speak formulation, is styled to include the trading of municipal debt securities as well as corporate equity and debt securities. The misappropriation theory shifts attention away from the qualitative variable of the relationship between informed and uninformed traders. It focuses instead on the nonpublic information variable and the manner in which the insider gained access to the information. If it is wrongful for a columnist of the \textit{Wall Street Journal} to provide tips on stocks about to be favorably mentioned in the newspaper,\textsuperscript{428} it is equally wrongful for a reporter of the \textit{Bond Buyer} to provide tips on bonds about to be mentioned in the newspaper calendar as subjects of a refunding.

The Supreme Court endorsed the misappropriation theory in \textit{United States v. O’Hagan}.\textsuperscript{429} The case involved a law firm partner who gained access to information within his firm that a client of the firm was about to make a tender offer for Pillsbury Company. O’Hagan thereupon purchased options and shares in Pillsbury Company stock, eventually making a $4.3 million profit. O’Hagan was indicted on fifty-seven counts including securities fraud in violation of section 10(b) of the 1934 Act and Rule 10b-5. The indictment relied on the misappropriation theory. The Supreme Court recognized that section 10(b) of the 1934 Act requires deceptive conduct and that a nondisclosure case requires a showing of a duty to speak. The duty to speak was found by the Court to reside in the fiduciary duty owing to the source of the information, the partner’s law firm and the firm’s client. Similarly to the manner in which the transaction fraud cases described above achieve a result by separating the application of the materiality and scienter elements,\textsuperscript{430} the \textit{O’Hagan} opinion concluded that the person defrauded need not be the other party to the trade but, instead, could be the source of the nonpublic information.

The Supreme Court in \textit{Chiarella} spoke of the absence of a fiduciary relationship between the printer and the sellers of the securities. The apparent contradiction is explained in \textit{O’Hagan} by insisting the holding in \textit{Chiarella} did not imply that the only relationship prompting liability for trading on undisclosed information is the relationship between a corporation’s insiders and shareholders. The misappropriation theory is viewed as complementing the “classical” theory of \textit{Chiarella} that applies when a corporate insider (including a temporary


\textsuperscript{428} United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986).


\textsuperscript{430} See section 8:9.
insider fiduciary such as an accountant, lawyer or consultant) trades in the securities of the insider’s corporation on the basis of material, nonpublic information. The Supreme Court in Chiarella did not consider the application of the misappropriation theory to the printer (which probably would have led to a different result) because the jury at the trial level had not been instructed on the misappropriation theory and it was therefore not before the Court on review. Chiarella and O’Hagan are made consistent in the O’Hagan opinion as follows:

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider’s breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate “outsider” in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to “[p]rotec[t] the integrity of the securities markets against abuses by outsiders to a corporation who have access to confidential information that will affect [the] corporation’s security price when revealed, but who owe no fiduciary or other duty to that corporation’s shareholders.”

The separation of the fraud from the trade in O’Hagan, by recognizing the “in connection with” clause of Rule 10b-5 does not require that the purchaser or seller of the defendant’s securities be the defrauded party, is essential to the misappropriation theory. This distinction is also crucial to the market integrity cases described below as fiduciary fraud because the market integrity cases involve a participant in the financing, such as a financial advisor defrauding another participant, such as an issuer, “in connection with” the sale of securities by the issuer, not the financial advisor. The fraud and the transaction are separated, but, nonetheless, it is securities fraud and not merely common law fraud because it is “in connection with” the sale of securities.

§ 8:11 Fiduciary Fraud; Market Integrity

Civil actions brought by plaintiffs, enforcement actions by the SEC, and criminal proceedings by the United States Justice Department (Justice Department) have been testing the legal obligations of participants in a municipal transaction to each other as well as to


432. See section 8:11.

433. For a review of SEC enforcement actions and Justice Department criminal proceedings related to fiduciary fraud in public finance, see chapter 13.
The theory behind these cases is that the securities laws and related criminal statutes are sufficiently broad to assure not only the integrity of material statements made to investors but also the integrity of the process by which transactions are formed prior to their being described in written official statements. This section will focus on material misstatements or omissions under Rule 10b-5(b), but issues of market integrity can also be approached as deceptive devices or fraudulent business conduct under Rule 10b-5(a) and (b).

The law of disclosure fraud, whether applied to defrauded investors or to a participant in a transaction, is generally divided into liability for

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434. The policy argument favoring a limitation of the securities laws to the protection of investors is found in statements of the Supreme Court such as its 1988 reference to the 1934 Act in Basic, Inc. v. Levinson, 108 S. Ct. 978, 982 (1988): “The 1934 Act was designed to protect investors against manipulation of stock prices.” A statutory policy that is broader than the protection of investors is, however, arguably signaled by other Supreme Court statements including United States v. O’Hagan, 117 S. Ct. 2199 (1997): “The [misappropriation] theory is also well tuned to an animating purpose of the Exchange Act; to insure honest securities markets and thereby promote investor confidence,” and SEC v. Capital Gains Research Bur., Inc., 84 S. Ct. 275, 280 (1963): “A fundamental purpose, common to these statutes, was to substitute a policy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.” The Conference Committee Joint Statement [41 CONG. REC. H 13692 (Nov. 28, 1995)] accompanying the Private Securities Litigation Reform Act [Pub. L. No. 104-67] (Reform Act) states: “The overriding purpose of our Nation’s securities laws is to protect investors and to maintain confidence in the securities markets….” Section 2 of the 1934 Act premises the purpose of the 1934 Act on the protection of the national “public interest” and cites such public interests as the protection of national credit, the federal taxing power and the banking system. Accordingly, § 15 of the 1934 Act, related to SEC market regulation powers, repeatedly authorizes the SEC to adopt rules for the protection of investors or appropriate “in the public interest.” Section 15B[2][b] authorizes the Municipal Securities Rulemaking Board [MSRB] to adopt rules “to remove impediments to and perfect the mechanism of a free and open market in municipal securities.” The existence of rulemaking powers to protect the integrity of the marketplace given to the SEC and the MSRB, however, raises the issue whether the SEC’s Division of Enforcement can properly bring an enforcement action under the general anti fraud provisions where neither the SEC nor the MSRB has exercised a corresponding substantive rulemaking power.

435. Justice Department jurisdiction is not limited by the terms of the securities laws. For example, the mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343 and 1346, do not limit the category of persons defrauded to investors or other persons closely connected to a purchase or sale of securities. The jurisdictional means for mail or wire fraud is the use of the mails or wires without a further limitation such as the requirement of Rule 10b-5 under the 1934 Act that the use of interstate commerce be “in connection with the purchase or sale of any security.”
misrepresentation and liability for nondisclosure.\(^{436}\) In a case of nondisclosure, Anglo-American law tilts in favor of the person choosing to remain silent requiring an affirmative duty to speak only in limited circumstances in which the defendant has a special relationship to the person injured or situations in which the nondisclosure substantially mimics a misrepresentation. Among these special relationships is that of a fiduciary having duties of loyalty and care to a beneficiary. In a case of misrepresentation, it is unnecessary to show a special relationship that legally impels an affirmative statement.\(^{437}\) By choosing to speak in a harmful manner, the defendant has created the necessary linkage between the defendant and the person injured.\(^ {438}\) The market fraud cases in public finance are likely to involve nondisclosure of either an underlying arrangement or a pecuniary opportunity resulting from the structuring of the transaction, and a showing of a duty to speak, such as that arising from a fiduciary relationship, will be central to a civil action, an enforcement action or a criminal proceeding. This section will discuss the characteristics of the public finance marketplace that give rise to the possibility of opportunistic behavior and will then consider whether particular circumstances involve a fiduciary relationship necessary for a civil action, SEC enforcement or Justice Department prosecution. Finally, the fiduciary duty exception to the general rule permitting nondisclosure of information will be placed in the context of other theories requiring the defendant to speak showing alternative bases for an obligation to make an affirmative statement.

§ 8:11.1  The Public Finance Participants

The type of fraud at issue in the market integrity cases may be illustrated as follows. A public power authority is issuing bonds to finance a new electric generating facility and distribution lines. The authority retains a financial advisor to assist it in preparing disclosure and to negotiate terms with the underwriter. The underwriter recommends to the authority that the payment of principal and interest on


\(^{437}\) RESTATEMENT (SECOND) OF TORTS § 525:

One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.

\(^{438}\) Glazer v. Sheperd, 233 N.Y. 236, 136 N.E. 275 (1922) (Cardozo, J.: the representation was made directly to the plaintiff “for the very purpose of inducing action”).

(Fippinger, Rel. #18, 7/09) 8–163
the bonds be insured by one of the “triple A” rated municipal bond insurance companies. The financial advisor strongly recommends to the authority that it select XYZ municipal bond insurer. The financial advisor fails to disclosure to the issuer that it has an underlying arrangement with XYZ to receive a kickback of a portion of the insurance premium. The official statement delivered to investors fully describes the electric revenues securing the bonds, provides complete information on XYZ and discloses the amount of the premium payable to XYZ from bond proceeds. The kickback from XYZ to the financial advisor is therefore probably irrelevant to investors, 439 nevertheless the financial advisor arguably has impeded the functioning of a free marketplace in connection with the distribution of securities.

There are several characteristics of public finance that may account for the perception at the SEC and the Justice Department that enforcement or prosecution is necessary to protect the integrity of the marketplace for the distribution of municipal securities when it is not clear that similar actions are being considered for the corporate marketplace. Most notably, the structure of the municipal marketplace lacks many of the oversight mechanisms inherent in the structure of corporations and their markets. Public finance is a debt market. There are no shareholders since the owner of a municipal corporation is the public. The policing function of shareholder meetings and proxy votes is lacking in the context of municipal financial decisions. There are approximately 50,000 issuers of municipal securities, and many of the persons acting in the capacity of a chief financial officer are part-time employees or generally lack the training likely to be the case for comparable personnel working for private corporations. Furthermore, many financial officers of municipal corporations do not have the support of a board of directors with expertise in matters of corporate governance and corporate finance. The public sector is characterized by a separation of powers that often results in an executive responsible for the issuance of municipal securities being separated from regular oversight. Public authorities and similar entities that do have a board of trustees or directors are likely to have trustees or directors with expertise in public policy issues and not the technicalities of public finance.

Municipal and corporate issuers also operate in different regulatory environments. Public finance is subject to significant securities law regulation, but issuers of tax-exempt bonds are generally not subject to the registration requirements of the 1933 Act or the line-item reporting requirements of the integrated disclosure system of the 1933 and 1934 Acts. The body of rules related to the distribution of corporate

firm securities requires corporate issuers to have in-house or outside lawyers with securities law experience. Corporate issuers and their underwriters are necessarily sensitive to securities law issues at the time a financing is being prepared. Without this disciplining function of detailed rules, participants in public finance may act without any awareness that their conduct raises securities law issues. Likewise, when the SEC becomes aware of an abuse in the conduct of the corporate markets there is a body of rules in place that either provides the basis for an interpretative release or a framework for a new rule. Much of the securities law of public finance is derived deductively from the antifraud rules, and the correction of an abuse is likely to prompt an enforcement action rather than an interpretative release or rulemaking.

Municipalities and the many political subdivisions that issue debt frequently must create complex financial structures to protect the interests of creditors because their source of repayment of debt, unlike a for-profit private corporation, is limited to a source of revenues secured by covenants or is part of a budget in which annual revenues are offset by annual expenditures. The elaborate financial structures to protect bondholder security, characteristic of today's public finance, further emphasizes the dependence of public officials on the expertise of investment bankers, financial advisors, consultants and lawyers. The potential gap in the expertise of public officials and the expertise required to fully comprehend complex financial structures provides the opportunity for abusive conduct by market participants.

The numerous participants in the structuring of a distribution of municipal securities may include the following:

1. **The Issuer.** The issuer of municipal securities is a State or a political subdivision. The vast number of political subdivisions in the United States consists not only of geographical subdivisions of governmental power into counties, cities, etc., but also subdivisions of State police powers to provide for the general welfare. These entities are frequently created by functional categories and include power authorities, airport authorities, public utility districts, housing agencies, educational authorities to finance universities, health authorities to finance hospitals, school boards, levy districts, pollution control districts, water supply authorities and others. Statutes creating these bodies define their purposes and the persons to whom they owe their primary loyalty.

2. **Separate Issuers.** Unlike the typical corporate issuer of equity or debentures, governmental issuers often issue bonds for the benefit of other government entities or
private corporations. The Internal Revenue Code requires the
issuer of tax-exempt securities to be a State or political
subdivision, but Congress has permitted numerous cat-
egories of tax-exempt financing in which the real party in
interest raising capital is a person other than the nominal
issuer. A health authority issues bonds and lends the
proceeds to private non-profit hospitals to finance hospital
facilities. The hospital has the benefit of lower interest rates
due to the exclusion of interest from the investor’s gross
income, and the hospital has the obligation to repay the debt
pursuant to a loan agreement. Representatives of both the
hospital and the governmental issuer will be participants at
working group sessions.

3. Bond Counsel. Bond counsel is a law firm that renders
an “approving opinion” as to the validity of the bonds and
the tax-exempt status of interest payments. The requirement
of a bond counsel approving opinion commenced in the late
nineteenth century at the initiation of investors who had
suffered major losses from States and political subdivisions
that renounced outstanding debt. Bond counsel firms origin-
ally were limited to a few specialists with issuers having
little flexibility in their selection. The number of bond
counsel firms has grown with issuers having considerable
freedom to select firms that will act in a traditional lawyer-
client relationship, but the bond counsel firm retains its
independent obligation to investors in rendering its approving
opinion.

4. Underwriters. As in corporate finance, investment bankers
underwriting municipal securities provide customary under-
writing service in the distribution of municipal securities.
Since bondholders' security is critical to public finance, the
underwriters may also become actively involved in structuring
the portfolio of investment securities purchased by the issuer
with bond proceeds pending disbursement of the proceeds for
construction, program or refunding purposes. In this capacity
the investment banking firm may be a seller of securities to
the issuer. Likewise, to “drive down” the cost of borrowing

\[\text{I.R.C. of 1986, as amended, § 103.} \]
\[\text{Id. § 141 et seq.} \]
\[\text{See National Association of Bond Lawyers, Model Bond Opinion Project} \]
\[\text{(1987 Revision) and The Function and Professional Responsibilities of} \]
\[\text{Bond Counsel (1987); and National Association of Bond Lawyers, State-} \]
\[\text{ment Concerning Standards Applied in Rendering the Federal Income Tax} \]
\[\text{Portion of Bond Opinions (1993).} \]
to the issuer, the investment banking firm may offer the issuer
derivative products, such as a swap transaction, in which the
investment banking firm has interests distinct from its con-
tractual underwriting responsibilities.

5. **Financial Advisor.** The issuer may choose to retain a financial
advisor in either an advertised offering subject to competitive
bid or a negotiated offering. In an advertised offering, the
underwriter is not selected until the sale date after the pre-
paration and distribution of a preliminary official statement.
The financial advisor will prepare the preliminary official
statement and supervise the sale and closing on behalf of the
issuer. In a negotiated offering, in which the underwriter is
selected earlier in the distribution process and is more likely to
be active in the preparation of disclosure documents, a finan-
cial advisor may be retained to represent the issuer in working
group sessions, advise the issuer on the underwriter’s recom-
mandations for structuring the financing, including the
investment of bond proceeds, and negotiate the underwriter’s
spread. Financial advisors may be broker-dealers subject to the
registration requirements of section 15 of the 1934 Act and
rules of the MSRB, but a large number of financial advisors
are “independent” of the broker-dealer requirements of the
securities laws.

6. **Corporate Trustee.** The commercial bank acting as trustee
under an indenture of trust is likely to have more responsi-
bility in public finance than its responsibilities under a corpo-
rerate debenture indenture. In addition to servicing debt and
overseeing covenants and remedies, the public finance trustee
is likely to hold bond proceeds and revenues collected to repay
debt as part of a trust corpus subject to an elaborate “flow of
funds” under the indenture, effectively creating a system of
financial governance for the benefit of investors. The trustee
therefore holds property of the issuer, the creator of the trust,
for the benefit of bondholders.

7. **Credit Enhancers.** The credit of a municipal structure depen-
dent on revenue sources or a budgetary process may not be
adequate to obtain interest rates at a level for efficient capital
formation. A municipal bond insurance policy can be nego-
tiated to insure the payment of the principal of and interest
on the debt thereby giving the financing a credit rating equal to
that of the insurance company. Alternatively, a letter of credit
can be negotiated with a commercial bank to give the finan-
cing the bank’s credit rating if the letter of credit is irrevocable
and adequate to cover principal and interest. A bond insurance premium is a one-time fee paid from bond proceeds at the time of issuance, and a letter of credit fee is paid annually from revenues.

8. **Guarantors.** The security of a transaction may be dependent on contracts or other agreements with credit-worthy third-parties who become active participants in the financing. For example, the public power authority financing of generating facilities and distribution lines may be dependent on contracts with one or more utility wholesalers for the purchase of the output of electricity.

9. **Consultants.** The market will often require feasibility consultants to be retained by the issuer to prepare a report, usually included in the official statement, as to the likelihood that revenues will be sufficient to cover debt service. The practice is commonplace for airport financings, other transportation issues, public power issues, water distribution financings and related public utility offerings.

**§ 8:11.2 Duty to Speak in a Nondisclosure Case**

The Supreme Court has repeatedly held that in a nondisclosure case a person is entitled to remain silent unless the circumstances are such that the person has a duty to speak.\(^{443}\) The Court’s interpretation of the antifraud rules under the securities laws and the mail or wire fraud statutes, allowing silence absent a duty to disclose, is based on comparable common law principles of fraud.\(^{444}\) For example, one illustration in the Restatement of Torts describes A, a violin expert who pays a casual visit to B’s shop where second-hand musical instruments are sold. A finds a violin which, on the basis of A’s knowledge, A recognizes as a genuine Stradivarius, in good condition and worth at least $50,000. The violin is priced for sale at $100. A does not disclose this information and buys the violin from B for $100. The commentary concludes that A is not liable to B as a result of the nondisclosure.\(^{445}\)

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443. Supra note 436.

444. Restatement (Second) of Torts § 551(1):

One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question.

445. Restatement (Second) of Torts § 551 cmt. on subsection (2), clause (e).
The circumstances that give rise to a duty to speak and thereby disallow nondisclosure may be derived from the securities laws or common law. Securities law obligations to disclose and not omit material information in light of the circumstances include

1. the periodic reporting requirements under the 1934 Act on Form 10-K and 10-Q for reporting companies,

2. the duty to correct previously disclosed information subsequently found to be incorrect,

3. the duty to release timely information pursuant to stock exchange rules,

4. the duty of insiders to disclose material non-public information or abstain from trading,

5. the obligation of reporting companies to make full disclosure upon the occurrence of a selective disclosure within the meaning of Regulation FD; and

6. the disclosure obligations at the time of the offer and sale of securities.

In addition to the requirements of the securities laws, a contractual obligation or a common law requirement may negate a person’s general right to remain silent. For example, financial advisors enter contractual agreements with issuers, and it is possible for those agreements to contain provisions that may fairly be interpreted as requiring disclosures of underlying relationships with third parties. MSRB Rule G-23 requires brokers, dealers and municipal securities dealers subject to the jurisdiction of the MSRB to evidence a financial advisory relationship with a written agreement with the issuer setting forth the basis of compensation for the financial advisory services. Rule G-23 does not currently require the agreement to disclose other sources of compensation received by the financial advisor as a result of the financial advisory relationship, but such an obligation could be

450. See section 6:9.
451. See section 6:3.

(Fippinger, Rel. #18, 7/09) 8–169
negotiated by the issuer and the financial advisor would thereafter not be able to rely on a nondisclosure right.

The most likely source of a duty to speak in a civil action by a private litigant, an enforcement action by the SEC or a criminal proceeding by the Justice Department is the common law obligation of a fiduciary to act loyally to the beneficiary of the fiduciary relationship. In the context of the market integrity cases, a determination of a person’s status as a fiduciary will require analysis of the particular situation. If a person is found to be a fiduciary, the fiduciary must avoid acts favoring the interests of the fiduciary or another person where the fiduciary’s or other person’s interests are in conflict with the beneficiary’s interests. Whether a particular withholding of information violates that duty must be analyzed under the circumstances. If a person found to be a fiduciary has acted inconsistently with a fiduciary duty by failing to disclose information, the fiduciary will be exposed to civil liability, an enforcement action or a criminal proceeding.

The application of the fiduciary duty to trump a right to remain silent may be illustrated by the jury instructions of Judge William Young in United States v. Ferber related to the mail and wire fraud counts. The factual background alleged in Ferber is summarized in the criminal indictment of Ferber and the SEC’s enforcement action resulting in a cease-and-desist order against Lazard Frères & Co. LLC and Merrill Lynch, Pierce, Fenner & Smith (Merrill Lynch). Mark Ferber was a former partner of Lazard and served as financial advisor to a water authority in Massachusetts. While Ferber was acting as a financial advisor to the water authority, Merrill Lynch in January 1989 submitted a response to a request for underwriter proposals to underwrite several billion dollars of bonds. In March 1989, Merrill Lynch was chosen as one of the three senior managing underwriters to rotate running the books on successive series of bond issues. In the fall of 1989 Merrill Lynch began attempting to convince the water authority to enter interest rate swap transactions in relation to upcoming financings in 1990. During this period, Merrill Lynch invited Ferber to Florida to receive education from Merrill Lynch on swap transactions (with Merrill Lynch as the counterparty) in the context of a pending Florida transaction. Merrill Lynch paid Lazard $90,000 in connection with the Florida transaction, and Ferber did not inform his partners that Lazard had not in fact worked on the swap.

452. Whether the common law duty is determined to reside in federal common law or state common law is a difficult and controversial issue but is not the subject of this article.

453. Jury Instructions, Cr. 95-10338-WGY, Aug. 6, 1996.

454. Indictment, Cr. 95-10338-WGY.

In December 1989, Merrill Lynch and Lazard entered a contract providing that the firms would split fees generated from any successful jointly marketed swap transactions. This contract was succeeded by a June 1990 contract between the firms providing for fee splitting and providing further that Lazard would consult with Merrill Lynch on the presentation of interest rate swaps and that Merrill Lynch would pay Lazard an annual fee of $800,000. In May 1990, with advice being rendered by Ferber, the water authority selected Merrill Lynch to execute interest rate swaps and to serve as book-running manager on a $717 million financing in March 1992.

The criminal charges against Ferber included mail and wire fraud counts. Judge Young’s instructions to the jury included the following:

Now, because this part of the case, the mail and wire fraud case, is a case of alleged nondisclosure, failure to disclose, I have to go over the specific elements in a nondisclosure case. So please follow me there as to these. [sic] that Mr. Ferber had a duty, the government has to prove beyond a reasonable doubt that Mr. Ferber had a duty to disclose. . .

Now, the duty to disclose can come from two separate sources. It can come from the contracts between Lazard Freres and the various agencies—Is there a promise in these contracts, or any of them, a promise on the part of Lazard Freres, which applied to Mr. Ferber, that Lazard Freres would make disclosures which Mr. Ferber was then obliged to make. That's one basis for the duty to disclose. But whether or not there was some contractual promise, did Mr. Ferber have a legal duty to make disclosure? And that turns on whether he was what’s called a fiduciary, in the law. A fiduciary is a special type of agent. An agent is just someone who performs services on behalf of another. A fiduciary is a special type of agent. A fiduciary is an agent who performs services on behalf of another under circumstances where Mr. Ferber knows that the other person or persons for whom he is performing those services, rely upon his knowledge of the specific field and likewise rely upon his devoting his unfettered services entirely to them with respect to that agency, that undertaking.

A fiduciary relationship existed if the government agencies placed reliance and trust in Mr. Ferber in a particular undertaking, if Mr. Ferber accepted the responsibility of that reliance and trust, if that reliance and trust was such that Mr. Ferber occupied a position of superiority in the relationship, and if the degree of reliance and trust placed in Mr. Ferber was reasonable.

Now, a contract by itself doesn’t create fiduciary duties. In determining whether Mr. Ferber was a fiduciary to the agencies, you may consider the amount of business sophistication of his
clients, what they possessed, the degree to which the agencies were capable of exercising independent judgment.

Now, if Mr. Ferber knows he’s a fiduciary, knows that people are relying upon him for these specific professional services and are relying upon his judgment, then he is held to a standard where he is obliged to disclose. Wholly apart from whatever any contract says, wholly apart from what the custom and procedure in a specific industry is, he is held by law to the duty to disclose those material things which the person who was employing him needs to know in order to make a determination about that employment.

Now, the second element in a nondisclosure case is, he didn’t disclose those things which it was his duty to disclose. The third element is that the information that he didn’t disclose was material. A material fact is one which a person would reasonably expect to be of concern to a reasonable government agency, active or preparing to be active, in the area of municipal financing; nondisclosure that would actually make a difference to a government agency in dealing with its financial adviser or making decisions with respect to municipal financing.\footnote{456}

\section*{§ 8:11.3 Determining Whether a Participant Is a Fiduciary}

There are few identifiable relationships that are invariably fiduciary in nature. There are however, four classifications of relationships that have traditionally given rise to the imposition of a fiduciary duty, but they each have been developed from different bodies of law applied over a long history of Anglo-American law. The varied sources of principles of fiduciary law necessarily implies that a simple formula to be applied to participants in a municipal securities transaction is not readily available.

The imposition of fiduciary duties on trustees, who hold and manage property on behalf of another, was created by courts of equity with their unique equitable remedies to recapture the trustee’s ill-gotten gains for the beneficiaries of the trust.\footnote{457} A second classification of fiduciaries is the representative whose duties were developed by common law courts as a branch of the law of agency, and available remedies were distinct common law remedies totally separate from those applied by equity courts to trustees. The third class is the advisor, and the advisor as fiduciary was an application of the law of

\footnotesize
\begin{itemize}
\item \footnote{456} Jury Instructions, Cr. 95-10338-WGY, Aug. 6, 1996, at 25–27.
\item \footnote{457} J.C. SHEPHERD, LAW OF FIDUCIARIES, 22–25 [1981].
\end{itemize}
undue influence, a relatively modern branch of jurisprudence with, yet again, its own remedies.\textsuperscript{458} Finally, corporate law evolved fiduciary responsibilities for directors owed to the corporation and to shareholders and also for majority shareholders of closely held corporations to minority shareholders. Corporate breaches of fiduciary duty will involve statutory law of the state of incorporation on issues of corporate governance, and, if applicable, federal securities laws. The hotly contested debates in recent years of the ability of corporations to avoid the implications of fiduciary status by contractually amended articles of incorporation has had a spill-over effect on the analysis of the more traditional classes of fiduciaries and whether they are a product of contract or involuntary duties resulting from circumstances.\textsuperscript{459}

[A] Property Theory

The traditional determination of a fiduciary duty of loyalty rests more in property and less in contract. A fiduciary relationship is fairly inferred from a fact situation whenever a person acquires a power of any type on condition that it is utilized in the best interest of another. The power is said to be a species of property to be beneficially owned by one person while it is being exercised by another who may be viewed as the legal owner of the power.

Paralleling the various sources of fiduciary law are competing theories of the foundation principles underlying fiduciary law. The property theory has its source in the law of trusts.\textsuperscript{460} A guardian is

\begin{itemize}
\item \textsuperscript{458} Id. 22–32.
\item \textsuperscript{460} \textit{RESTATEMENT (SECOND) OF TRUSTS} § 170:
\begin{enumerate}
\item The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary.
\item The trustee in dealing with the beneficiary on the trustee’s own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know.
\end{enumerate}
\end{itemize}

Among the fiduciary duties imposed on corporate trustees is the prohibition on the trustee from purchasing property for the trusts from one of its departments, such as the purchase from bond proceeds securities held by the trustee in its banking or trust departments. \textit{RESTATEMENT (SECOND) OF TRUSTS} § 170, comment (j) to section 1. Likewise, the trustee is precluded from using bond proceeds or reserve funds held under the indenture in shares of the bank itself. \textit{RESTATEMENT (SECOND) OF TRUSTS} § 170,
entrusted with property in the form of securities to be invested for the benefit of minor children. The guardian has power over the use of the securities, and the beneficiaries are exposed to the risk that the property will be misappropriated. Treating the subject of the fiduciary duty as property, including the fiduciary’s bundle of assets, powers and opportunities, courts are in a position to apply the remedy of restitution by viewing the facets of the fiduciary’s performance as property of the beneficiaries. In the power authority illustration where the financial advisor recommends a municipal bond insurer from whom the advisor is receiving a kickback, the kickback can be considered the property of the power authority since it is traceable to the power authority’s bond proceeds from which a premium was paid and a portion subsequently diverted to the fiduciary. The property theory is weakest in circumstances where the abuse does not relate to assets but to advice, such as improperly advising a client to invest in a security to shore up its value to protect the fiduciary’s investments in the security held on behalf of other clients of the advisor.

comment (n) to section 1. The restrictions on corporate trustees derived from the duty of loyalty have resulted in the extensive drafting of an article of the trust indenture applicable to the trustee. Counsel for the trustee relies on the consent exception set forth in comment (a) to § 170:

A trustee is in a fiduciary relation to the beneficiary and as to matters within the scope of the relation he is under a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so by the terms of the trust or by a proper court.

By purchasing the bonds, bondholders, as beneficiaries of the trust indenture, consent to the terms of the trust indenture. Without careful drafting of trust indentures and related documents, trustees can be placed in the position of having conflicting obligations. For example, SEC Rule 15c2-12[b][5] relating to continuing disclosure by States and political subdivisions, may result in documents drafted requiring the trustee to report to public repositories the occurrence of certain events. The disclosure may result in the value of the bonds declining to the detriment of bondholder interests. RESTATEMENT (SECOND) OF TRUSTS § 170, comment [s] provides:

The trustee is under a duty to the beneficiary not to disclose to a third person information which he has acquired as trustee where he should know that the effect of such disclosure would be detrimental to the interest of the beneficiary.

To prevent the trustee from being entrapped by a conflict between fiduciary duties and disclosure responsibilities, the documents should be drafted to allow a fair interpretation that the bondholders consent to the disclosure.
[B] Reliance Theory

To account for circumstances lacking property or property-like assets, many courts refer to fiduciary relationships in terms of reliance—that the beneficiary has reposed trust, confidence, and reliance in another. The difficulty in this generalization is that it applies too broadly.\textsuperscript{461} We all rely and place trust in plumbers, electricians, butchers, and many others but this reliance does not render them our fiduciary. Other statements confine the reliance to circumstances in which there is an “inequality of footing” between the two parties. This formulation has the benefit of emphasizing the vulnerability of the beneficiary to the conduct of the fiduciary, but the net again casts too broadly. The homeowner is likely to be uninformed about electricity and entirely vulnerable to the potential of physical harm if the electrician is negligent. Nevertheless, the law deals with this form of vulnerability with a series of implied warranties and not the imposition of fiduciary duties. The vitality of the reliance and unequal relationship theories is most prominent where the persons being considered for fiduciary status are advisors, including investment advisors and financial advisors.\textsuperscript{462}

[C] Contract Theory

For those situations in which the fiduciary was not a recipient of property or property-like assets capable of misappropriation or the beneficiary of the relationship was not of “unequal footing” or vulnerable in the usual sense, an alternative theory was necessary. The law has recognized that even the non-vulnerable person who chooses to place affairs in the care of another ought not to incur the transaction costs of overseeing the performance of the fiduciary, and therefore the fiduciary’s actions are encumbered with a duty of care and a duty of loyalty. The prototype for this type of fiduciary is the agent, employee, or representative. The premise is that the agent undertakes to act in the interest of another person, and an undertaking is suggestive of a contractual relation. The settlor or beneficiary is said to make an offer to the agent agreeing to repose a trust in the agent, and the agent accepts the offer by agreeing to act loyally and with care. The implications of fiduciary duty superimposed on a contract and the expansion of remedies available to the beneficiary resulting from the relationship are summarized in the \textit{Restatement of Agency}:

However, although the agency relation normally involves a contract between the parties, it is a special kind of contract, since an agent is not merely a promisor or a promisee but is also a fiduciary.

\textsuperscript{461} SHEPHERD, supra note 457 at 56–64.
\textsuperscript{462} Id.
Because he is a fiduciary and is subject to the directions of the principal, the rules as to his duties to the principal are unique. Substituting for the terms of the trust the will of his principal, his fiduciary duties are similar to those of a testamentary trustee to the beneficiaries. Further, since the contract of employment, if there is one, is ordinarily not spelled out in detail but depends for its interpretation upon evidence as to the customary way of doing business, the generalizations which can be drawn concerning the agent’s duties are inferences of fact which are permissible only in the absence of a specific understanding otherwise. In the absence of fraud, duress or illegality, any agreement between the parties will be enforced, at least to the extent of granting a cause of action for its breach.  

This linkage of fiduciary law with contract law inevitably has raised the issue of possibly modifying fiduciary duties by the terms of the contract. Historically, fiduciary duties were thought to be involuntarily imposed by law, but the contract theory has suggested the alternative that fiduciary obligations were properly the subject of negotiation. The appeal of this view is that the duty of care and the duty of loyalty can be tailored to meet the requirements of the circumstances. The potential of this flexibility was seized upon in the 1970s and 1980s in attempts to find contractual methods of modifying the fiduciary duties of corporate managers and directors to the corporation or shareholders and majority shareholders to minority shareholders in a closely held corporation. The advocates of flexible duties of corporate governance, often linked to law and economics jurisprudence, were referred to as “contractarians” and their opponents favoring more involuntary court-determined fiduciary duties were referred to as “anti-contractarians” or “regulators” in response to the “de-regulatory” agenda of the contractarians.

The contractarian argument is to allow free bargaining to achieve overall corporate efficiency. Contractarians view the corporation as a

463. Restatement (Second) of Agency § 376, Introductory Note.
464. The contract theory was the first modern attempt to modify common law, and its genesis is credited to a 1949 article by Austin Scott: Scott, The Fiduciary Principle, 37 Cal. L. Rev. 521 (1949).
series of private contractual relationships among officers and directors as providers of services and shareholders as providers of capital. To achieve economic efficiency, resources should be allocated to the party willing to pay the most for a particular resource. Officers and directors are sellers of fiduciary protections, and corporations and their shareholders are buyers of fiduciary protections. An economically efficient allocation of fiduciary duties can be achieved only through free bargaining. A mandatory imposition of fiduciary duties that is incapable of modification by contract disrupts the process of achieving efficiency. For example, some corporations might place a low value on a director’s duty of care or loyalty because other mechanisms are in place to prevent harm from director’s lack of care or loyalty. In these circumstances directors should be allowed to negotiate a lower level of fiduciary duty, perhaps receiving less compensation, but freeing the director to pursue independent interests without the impediments of fiduciary duties to the corporation. By allowing the director’s energies to be applied elsewhere there is an overall gain in efficiency to the economy.

The anti-contractarians challenge the reality of the corporation as a nexus of freely negotiated contracts. Shareholders are diverse, lack information and are ill-suited to equal bargaining with managers. Investment decisions are unlikely to be based on whether the drafting of a corporate charter contains opt-out provisions negating the normal application of traditional protections of shareholders such as insider trading rules or the duty of loyalty. Even closely held corporations, where shareholders are more likely to be familiar with manipulations of corporate structure, have been the victims of notorious freezeouts that have resulted in efforts to improve the functioning of fiduciary duties owed by majority shareholders to minority shareholders. DeMott has shown the shortfalls of contractual principles of fair dealing as a source of protection when compared with the imposition of fiduciary duties. McDaniel has observed that the theoretical debate illustrates the unconcern of economists about losses to


469. DeMott, supra note 459 at 892 ff.
individuals but that judges do care about individual losses and are likely to retain the law of fiduciary duties. Frankel has proposed that if contractual flexibility is desirable, the starting point should be that traditional fiduciary duties are in place and that they may be waived if procedures are followed to protect beneficiaries. She has suggested a two-step procedure beginning with a clear notice that, with respect to particular duties, the beneficiary will no longer be able to rely on their fiduciaries, and beneficiaries must therefore find alternative means to protect themselves. In addition, she would require fiduciaries with information acquired by virtue of their position as fiduciaries to enable beneficiaries to make an informed independent decision regarding the waiver.

[D] Transfer of Encumbered Power Theory

The contractarians are not likely to bring about major changes in fiduciary law, but their arguments have forced traditional commentators to seriously consider the desirability of fiduciary duties that are capable of adjustment in light of circumstances. The transfer of an encumbered power theory represents an attempt to accommodate contractarian benefits without succumbing to a potential power struggle between the beneficiary and the fiduciary in defining fiduciary duties. A fiduciary relationship is said to exist whenever a person acquires a power on condition that the recipient has a duty to utilize the power in the best interests of the entrustor.

The transfer of encumbered power theory has several advantages in public finance that point to the weaknesses of the theories described above. The property theory is limited because, with the exception of trustees acting under a trust indenture, most participants in a municipal securities transaction are not the holders of the property of another. Various participants may be entrusted with significant powers to effectuate all or a portion of a financing on behalf of another, particularly an issuer, without there being a transfer of property. Theories that are based on the possibility of undue influence, including the reliance theory, are limited because the entrusting of power may not signal an unequal relationship. A highly sophisticated issuer of municipal securities could determine that it is more efficient for a financial advisor to structure a bond issue if the issuer’s personnel are more usefully employed on policy or program matters. The issuer entrusts another with the power to effectuate a transaction, but the issuer is not necessarily incapable of fending for itself.

471. Campbell, supra note 466.
472. SHEPHERD, supra note 457.
Advocates of the transfer of encumbered power theory recognize that fiduciary relationships should be capable of modification by contract and not be locked into preexisting common law forms. The ability to adjust fiduciary duties in light of modern commercial and financial circumstances allows the concept to be applied in a larger number of situations. By recognizing the open-textured possibilities of fiduciary law its advocates have prevented fiduciary concepts from being buried in common law history.\textsuperscript{473} However, the anticontractarians were quick to recognize that a contract theory allowed the person having the stronger bargaining position, who is the recipient of a power, to opt out of duties to utilize the power for the benefit of another. The transfer of encumbered power theory attempts to switch the emphasis from the bargained-for contract to the intent of the entruster.\textsuperscript{474} The fiduciary must accept the power, as in a contractual analysis, but the beneficiary is the author of the power.

\section*{§ 8:11.4 Government Officials As Fiduciaries}

The contract theory implies that powers are contractually transferred and the result of the negotiations of an agreement. A power encumbered with a duty, however, may also be transferred by appointment or election to an office. Thus a person elected to the board of directors of a corporation is said to have duties of care and loyalty by reason of the appointment. Likewise, a governmental official is entrusted with powers, and the official is generally thought not to be in a position to negotiate the level of care and loyalty owed to the public.\textsuperscript{475}

The fiduciary duties of public officials are rooted in the social contract theories of post-Hobbesian classical liberalism. By receiving appointment or election to an executive, legislative or judicial position, the official is bound to act for the benefit of the public. The public dictates the terms of the social contract, and the official accepts those terms by accepting the office. The public entrusts the official with certain powers on condition that the official receive the powers coupled with a duty to utilize them in the best interests of the public.\textsuperscript{476}

The fiduciary duty of public officials is the backbone of the mail or wire fraud cases brought against public officials.\textsuperscript{477} The public’s “intangible right” to honest and faithful services of public officials will form the predicate of a mail or wire fraud criminal proceeding if

\begin{footnotesize}
473. DeMott, \textit{supra} note 459.
474. \textit{Shepherd}, \textit{supra} note 457.
477. See section 13:6.1[A].
\end{footnotesize}
the official uses the entrusted power to benefit persons other than the public. When the official violates the duty of loyalty entrusted by the transfer of power, the official violates a fiduciary duty. The violation is fraudulent because the duty of loyalty imposes on the official an obligation to inform the public beneficiary of conduct detrimental to the interest of the beneficiary, including detrimental conduct by the fiduciary. Nondisclosure of material information by a governmental official in a fiduciary capacity is considered fraudulent conduct comparable to a harmful misrepresentation by a person in a principal (and non-fiduciary) relationship with another.

In discussing fact patterns involving fiduciary fraud issues, it is common for there to be statements to the effect that a public official or another fiduciary had a conflict of interest or failed to disclose a conflict of interest. In considering the relationship between a beneficiary and a fiduciary, however, it should not be difficult to recognize that a conflict of interest is frequently embedded in the relationship. Common law does not require an identity of interest between the fiduciary and a beneficiary. Fiduciary duties are imposed by law to prevent the fiduciary from choosing the wrong interest when a bias toward self-interest or the interests of persons other than the beneficiary arises.478 Fiduciaries, including public administrators, are

478. It is common in the literature for the term “conflict of interest” to refer, not to the point of time a bias arises against the interest of the beneficiary, but to the time the fiduciary acts contrary to the interest of the beneficiary. Statutory provisions will frequently avoid applying the term “conflict of interest” to the time at which the public’s interest and the personal interest of the public official potentially diverge, but instead make it unlawful for the public official to participate in a governmental decision when the official has an interest. For example, the California statute provides as follows:

No public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a government decision in which he knows or has reason to know he has a financial interest.

CAL. GOV’T CODE § 87,100.

The New York statute requires “any municipal officer who has, will have or later acquires an interest in any actual or proposed contract with the municipality” to disclose the nature of the interest. N.Y. GEN. MUN. LAW § 803. The existence of the interest therefore appears to require affirmative action even prior to participation in a governmental decision. See Landau v. Perracciolo, 66 A.2d 80, 412 N.Y.S.2d 378 [1978]. State and federal statutes provide detailed requirements for executive, legislative and judicial officials to respond to circumstances in which a conflict arises. Notification of the conflict to a designated person or body and abstention from participation in any governmental action related to the interest is typical, but the timing of notice and related procedures are subject to significant variation.
frequently selected because of their business experience in transactions of the type that is the subject of the beneficiary’s interest, and the fiduciary’s experience is likely to make the fiduciary knowledgeable in profit-making opportunities. As a practical matter, conflicts of interest are likely to arise numerous times in the ordinary course of the fiduciary acting pursuant to the powers transferred from the beneficiary.

At common law, the fiduciary engages in misconduct, not at the point a conflict arises but when the fiduciary chooses to act contrary to the interests of the beneficiary. Under modern statutes regulating public officials, the obligation to take steps to avoid the conflict is likely to occur at an earlier time when the official is in a position to participate in a governmental action relevant to the competing interests. If the conflict is between the interests of two beneficiaries represented by the same fiduciary, it will be necessary for the fiduciary to take steps to eliminate the conflict.\(^{479}\) However, if the conflict is between the interests of a single beneficiary and the fiduciary, the law of fiduciaries does not punish the fiduciary who has a conflict of interest, but imposes liability only when the fiduciary utilizes the entrusted power to promote the interest of someone other than the beneficiary. The liability is for breach of a duty of loyalty.\(^{480}\)

For example, a public official may have a choice between two insurance companies for providing liability insurance to the government.\(^{481}\) One insurance company provides a better level of benefits and a lower premium, but the other insurance company made substantial campaign contributions to the official in the expectation of being awarded the insurance contract. At the time the official is faced with a choice there is a conflict of interest. The interest of the public as beneficiary of the fiduciary’s duty is in conflict with the self-interest of the official to award the contract to the insurance company.

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479. For example, the American Bar Association Rules of Professional Conduct prohibit a lawyer from representing a client if that representation will be directly adverse to an existing present client or if the representation would be materially limited by the lawyer’s responsibility to a present client. Likewise, a lawyer is prohibited from representing a client if the interests of the client are materially adverse to the interests of a former client and the current matter is the same or substantially related to the former client. The commencement of the second representation causes the conflict, and to avoid the conflict of interest the lawyer must either refuse the second representation or obtain waivers consenting to the conflict of interest from each present or former client. Accepting the second client without disclosure and obtaining waivers would be analogous to the fiduciary who chooses the fiduciary’s own pecuniary interest over the beneficiary’s interest.

480. SHEPHERD, supra note 457.

making the campaign contribution. There is no common law liability based solely on the existence of the conflict, but the official has a clear duty to select the insurance company most beneficial to the interests of the public.\footnote{482} Assuming the official does select the insurance company promoting the public interest, the conflict of interest will cease, and there will be no liability for the existence of the conflict of interest. Likewise, if the official chooses the insurance company making the campaign contribution, technically the conflict of interest may again be said to cease, but the official will be exposed to a criminal charge of abuse of power.\footnote{483} It follows that when a breach of state law fiduciary duty is converted to fraudulent conduct under the federal securities laws or the federal mail or wire fraud statutes, the wrong is not a conflict of interest but the nondisclosure of the breach of a duty of loyalty.

To prevent a breach of fiduciary duty from also being fraudulent conduct it is necessary for the fiduciary to disclose information material to a beneficiary’s decision to act or refrain from acting in a business transaction prior to the time the beneficiary acts or refrains from acting. In the illustration of the awarding of the insurance contract, the government official who recommends the insurance company that made campaign contributions may be in violation of abuse of power statutes immediately upon the recommendation of the company not representing the public’s interest if the public official has not followed statutory disclosure procedures. Both state and federal statutes strictly govern the disclosure requirements for public officials.\footnote{484} The nondisclosure element of a fraud action will ripen at the time the legislative body or other government agency acts on the recommendation and the official has continued to fail to make the disclosure.

\section*{§ 8:11.5 Underwriters of Municipal Securities}

An investment banking firm acting as an underwriter of municipal securities is not a fiduciary of the issuer. The bond purchase agreement or underwriting agreement is drafted to provide that the underwriter is acting as a principal in an arm’s-length relationship with the state or political subdivision issuing debt. No issuer of municipal securities subjected to presentations and selling activities by investment bankers should be under the misunderstanding that an underwriter is an employee or agent of the issuer. In addition to the contractual provisions of the bond purchase agreement or underwriting agreement, the

\footnotesize

\footnote{482} SHEPHERD, supra note 457.  
\footnote{483} Id.  
\footnote{484} See, e.g., supra note 478.  

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federal securities laws emphasize the underwriter’s duties to investors, and to fulfill its obligations to investors, the underwriter will generally engage in due diligence activities with the issuer to be reasonably assured the issuer is not making any material misstatements or omitting material information in the disclosure document distributed to the investor.

The first sentence of a typical bond purchase agreement or underwriting agreement signals that the investment banking firm is acting in a principal capacity. In fact, the trend in recent years to refer to the agreement to underwrite fixed-income securities as a bond purchase agreement rather than an underwriting agreement is to emphasize in the title that the investment banking firm is a principal and not an agent. The term “underwriting agreement” is not intended to suggest anything other than a principal to principal relationship, but the term “bond purchase agreement” leaves no room for doubt.

A brief walk through a bond purchase agreement makes clear that, while the investment banking firm views an issuer, who pays the underwriter’s fee, as a client and will render advice to the issuer on the structuring and marketing of securities, the investment banker’s responsibilities are directed to the investor. The bond purchase agreement has an introductory section describing the financing in the form of a disclosure by the issuer to the underwriter stating that what is described in the official statement, the trust indenture, the bond resolution or other basic documents is, in fact, the structure of the financing. The introduction is followed by representations of the issuer as to the nature of the transaction, covenants of the issuer to assure the continuation of the representations and the continuation of the disclosure of information after the date of execution of the bond purchase agreement. These provisions are followed by requirements for closing. If the enumerated documents are not produced at the time of closing to the satisfaction of the underwriter or its counsel, there will be no obligation for the underwriter to accept delivery of the bonds. Supplementing the conditions to closing are termination provisions, which are contractual agreements that, if specified circumstances arise, the underwriter will be entitled to terminate its obligation to purchase the bonds. There can be no doubt in reading a bond purchase agreement that the underwriter is acting as a principal with an issuer, and the language of the bond purchase agreement contains no implication that the underwriter is a fiduciary.

The genesis of the contractual provisions of a bond purchase agreement is the underwriter’s obligations under the federal securities laws. It is the position of the SEC that by participating in an offering, an underwriter makes an implied recommendation about the securities that requires the underwriter to have a reasonable basis for the accuracy and completeness of key representations made by the issuer.
in the official statement. Accordingly, the flow of information established by the bond purchase agreement is from issuer to underwriter. This relation directly contrasts with a fiduciary relation that would reverse the flow of information under the common law requirement that a fiduciary has an obligation to disclose information to the beneficiary that would materially affect a decision by the beneficiary to act in a business transaction.

The underwriter of municipal securities performs a number of tasks to assist the issuer in achieving a successful distribution. Public finance is characterized by debt issues that require careful structuring to assure the security of the issue. An important element of disclosure is the investment of funds including the proceeds of an issue. In the normal course of underwriting, investment banking firms make recommendations to issuers as to the investment of funds and frequently assist issuers in the making of investments, particularly bond proceeds, to assure the investments are consistent with disclosure. These activities are incidental to the underwriting of debt securities in the structured public finance marketplace and should not be viewed as reorienting the relation between issuer and underwriter.

The relation between issuer and underwriter may, however, shift if the underwriter becomes a broker or dealer of the investment securities being sold to the issuer. The issuer is then in the position of a customer of a broker or a dealer and will be owed the duties applicable to broker-dealers under the federal securities laws. Generally, a broker, who is an agent acting on behalf of a customer, is considered a fiduciary of the customer. A dealer will only be considered a fiduciary if particular facts and circumstances indicate that a customer has transferred power to the dealer encumbered with fiduciary obligations. Brokers, dealers, and municipal securities dealers, regardless of fiduciary disclosure obligations, are subject to suitability, fair dealing, anti-churning, and anti-manipulation rules.

[A] **United States v. Cochran: Cochran 1**

Robert Cochran was convicted of wire fraud in May 1996 and sentenced to eighty-seven months’ imprisonment. In March 1997, the Tenth Circuit overturned the conviction. Cochran’s investment

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487. For markup disclosure distinctions between brokers and dealers, see Exchange Act Release No. 33,743 [Mar. 9, 1994].
banking firm, Stifel, Nicolaus & Co., Inc., was appointed underwriter for bonds issued by the Oklahoma City Airport Trust Authority (OCAT) and the Sisters of St. Mary’s Healthcare System (SSM). Following customary procedures in public finance, Stifel’s services as underwriter included making arrangements for the investment of the issuer’s bond proceeds. In both the OCAT and the SSM transactions, Stifel negotiated investment contracts. The fraudulent scheme alleged in the indictment involved fees paid to Stifel by the providers of the investment contracts without any person representing OCAT or SSM being informed of the payments to Stifel. 489

The OCAT wire fraud count in the indictment charged both nondisclosure and misrepresentation. 490 The alleged nondisclosure was the failure to inform OCAT that, in addition to its underwriting fee, Stifel intended to receive a separate fee from the Finnish bank providing the investment contract. The alleged misrepresentation was the statement by Garrett, an associate of Cochran and co-defendant, that the rate of interest on the reserve fund investment contract the bank was willing to pay was 6.5%, when, in fact, the bank was willing to pay 7.0% and the short-term rate for the construction fund contract was 3.95% when, in fact, the bank was willing to pay 4.2%. The 6.5% and 3.95% rates disclosed to the issuer represented a deduction of fifty and twenty-five basis points from the 7.0% and 4.2% rates, respectively, to account for the undisclosed fee. The misrepresentation in SSM, which was a tax-exempt refunding transaction, was premised on the closing certificate signed on behalf of Stifel to the effect that, except for the bank’s fee, no other payments were made in connection with the purchase of the forward supply contract.

Chapter 13 includes a detailed criticism of Judge Thompson’s jury instructions for their failure to distinguish misrepresentation and nondisclosure and the absence of instructions on the necessity to establish a fiduciary or related duty to speak in a nondisclosure case. 491 The instructions were silent on the relationship of an underwriter to the issuer, and no distinction was made between an underwriter and a financial advisor, or other participants who arguably act as agents of the issuer.

The opinion of the Tenth Circuit overturning the conviction focused on the duty to speak issue. The Court cited Chiarella (“when an allegation of fraud is based upon nondisclosure, there can

489. The facts as alleged by the SEC in their injunctive action are described in more detail at section 13:3.3[B]. See also section 13:6.1 for a summary of criminal charges.
490. Indictment, Cr. 95-128-T, Count 3, ¶ 8, 9.
491. See section 13:6.1[A].
be no fraud absent a duty to speak")\textsuperscript{492} and United States v. Irwin ["there can be no criminal conviction for failure to disclose when no duty of disclosure is demonstrated"]\textsuperscript{493} in determining that the government failed to prove the existence of a known duty for Cochran to disclose the fees. "At oral argument, the government could not inform us of any statute, regulation, common law or contractual provision that required disclosure of the fee."\textsuperscript{494}

In fact, the Tenth Circuit's opinion itself provides a basis for concluding Cochran owed a fiduciary duty. The OCAT transaction involved the investment of bond proceeds in a guaranteed investment contract (GIC). Cochran contacted Pacific Matrix Financial Corporation [Pacific Matrix] to find a financial institution to provide the GIC. Pacific Matrix selected Postipankki Bank of Finland to provide the contract for the reserve fund and construction fund investments. The difference between the gross and net bids described above were, in the words of the opinion, "to account for the \textit{broker fees} charged by \textit{Stifel} and Pacific Matrix [emphasis added]." The opinion further states: "In addition to acting as underwriter for the offering, Stifel also \textit{brokered} [emphasis added] a collateralized guaranteed investment contract between OCAT and the Postipankki Bank. . . ." The closing certificate signed by Stifel in the SSM transaction is described by the court as a "\textit{broker's}" certificate, and the certificate refers to Stifel as the "Broker." The distinction between a broker and a dealer under the 1934 Act's section 3(a)(4) and (5) definitions is that a broker acts as an agent for its customer and a dealer acts as a principal. An agent is ordinarily a fiduciary to the agent's principal, and therefore the Tenth Circuit had a clear path to finding Stifel owed a fiduciary duty to both OCAT and SSM.\textsuperscript{495}

[B] \textbf{SEC v. Cochran: Cochran 2}

In addition to the criminal case brought by the government against Cochran resulting in the Tenth Circuit's reversing the conviction in Cochran 1, the SEC brought a civil action that also found its way to the Tenth Circuit\textsuperscript{496} as Cochran 2. The SEC's complaint in Cochran 2 focused on two transactions that were not at issue in Cochran 1.
The first was an advance refunding bond issue for the Oklahoma Turnpike Authority (OTA). The escrow funds were invested pursuant to a forward purchase agreement with Sakura, after Cochran selected Sakura as the winning bidder. The SEC alleged that Cochran rigged the bidding to assure Sakura would be the winner, that Sakura paid Stifel $6.5 million in relation to the transaction, and that the payment was not disclosed to OTA. The second transaction was a revenue bond issue by the Pottawatomie County Development Authority (PCDA), and part of the proceeds were used to purchase a guaranteed investment contract (GIC). Pacific Matrix solicited bids for the GIC, and 80% of the fee paid to Pacific Matrix was paid by Pacific Matrix to Stifel, allegedly without disclosure to PCDA.

The SEC alleged that Cochran’s failure to disclose to OTA and PCDA, respectively, the payments from Sakura and Pacific Matrix, violated the antifraud provisions of the securities laws, including section 17(a) of the 1933 Act, Rule 10b-5 under the 1934 Act, and MSRB Rule G-17. Cochran filed a motion for summary judgment arguing he was under no duty to disclose the payments. The district court granted the motion, stating that the SEC failed to articulate any theory giving rise to a duty of Cochran to make the disclosures to OTA and PCDA.

The Tenth Circuit reversed, holding that the evidence in the record was sufficient to create a genuine issue as to whether there was a relationship of trust and confidence creating a duty in Cochran to make the disclosures. The court reasoned that under Chiarella, a Rule 10b-5 fiduciary duty can be found under a federal statute or the statutory or common law of the state that is the locus of the defendant’s conduct. In reversing the district court, the Tenth Circuit cited Oklahoma cases for the following conclusions under the law of Oklahoma, the locus of Cochran’s activity:

1. A fiduciary relationship does not rest on any particular relationship but rather springs from an attitude of trust and confidence and is based on some form of agreement, either expressed or implied, from which it can be said the minds have met to create a material obligation.

2. Even absent a fiduciary relationship, the relationship of the parties, the nature of the subject matter of the contract or the peculiar circumstances of each particular case, may be such as to impose a legal or equitable duty to disclose all material facts.

497. Id. at 1263–64.

(Fippinger, Rel. #18, 7/09) 8–187
(3) When one party expressly or implicitly agrees to act as an agent or broker on behalf of another party, Oklahoma law imposes on the agent a fiduciary duty to disclose to the principal all material facts within the scope of the agency.\footnote{498}

The court emphasized the obligation of a broker:

\begin{quote}
The rule requiring a broker to act with the utmost good faith toward his principal places him under a legal obligation to make a full [sic] fair, and prompt disclosure to his employer of all facts within his knowledge which are or might be material to the matter in connection with which he is employed.\footnote{499}
\end{quote}

While the court states that the events occurred while Stifel was acting as an underwriter, the opinion appears to distinguish Cochran’s role as an agent for purposes of assisting OTA and PCDA in the investment of bond proceeds. For example, the opinion states that “Cochran . . . agreed to purchase a GIC as the PCDA’s agent while still acting as lead banker for the underwriter of the bond issue the proceeds of which were used to make the purchase.”\footnote{500} And, “the parties mutually agreed Cochran would act as OTA’s agent in soliciting bids for, and negotiating the terms of, the forward.”\footnote{501}

The court distinguished \textit{Cochran 1}, where it found no fiduciary relationship, stating that \textit{Cochran 1} related to different transactions and a substantially different factual record. The record in \textit{Cochran 1} failed to provide adequate evidence that the issuers intended Cochran to act as their fiduciary. “By contrast, in the present case officials with both the PCDA and OTA testified that Cochran acted not merely as an underwriter but also as the agencies’ advisor and agent during the reinvestment phase.”\footnote{502} Again, the court is distinguishing Cochran in the role of underwriter from his role as an agent.

\section*{[C] \textit{SEC v. Terry D. Busbee & Preston C. Bynum}}

The SEC filed a complaint for injunctive relief in the District Court for the Northern District of Florida in January 1995 against Terry Busbee, an elected public official, and Preston Bynum, an investment banker. The facts alleged by the SEC are set forth in Chapter 13.\footnote{503} Briefly, Bynum caused Busbee to receive personal loans and other benefits at a time when Bynum was seeking underwriting business from the Escambia County Utilities Authority [the ECUA] and at a
time when Busbee was in a position on the ECUA to play an important role in the selection of underwriters.

On three separate occasions Busbee was instrumental in having Bynum’s employer, Stephens Inc., appointed underwriter of municipal securities issued by the ECUA. Neither Busbee nor Bynum disclosed the financial benefits received by Busbee to the other officials of the ECUA, and there was no disclosure of the underlying arrangement to investors in the official statement. The SEC’s complaint charged that “Busbee and Bynum each had a duty to disclose the arrangements described . . . above to the ECUA in connection with the selection of Stephens as the underwriter in the three offerings, and to investors in the three offerings.”

Busbee consented to the entry of a final judgment permanently enjoining him from future violations of the antifraud provisions of the federal securities laws. In a criminal proceeding brought by the Department of Justice on the same facts, Busbee pleaded guilty to one count of bribery and one count of federal income tax evasion, receiving a sentence of twenty-seven months in prison and three years’ probation. Without admitting or denying the allegations in the complaint, Bynum consented to the entry of a final judgment permanently enjoining him from future violations of section 17(a) of the 1933 Act, sections 10(b) and 15B(c)(1) of the 1934 Act, Rule 10b-5 thereunder, and MSRB Rules G-17 and G-20. In addition, Bynum paid $25,000 in civil penalties and consented to an order barring him permanently from association with any entity regulated by the SEC. In a related criminal case brought by the Department of Justice, Bynum pleaded guilty to one count of bribery and received a sentence of twenty-four months in prison and two years’ probation.

The SEC’s complaint in its injunctive action stated that Busbee and Bynum had not disclosed the underlying arrangement to the ECUA. The case was therefore one of nondisclosure, and the SEC was obligated to show a duty to speak. The complaint states the SEC’s conclusion that Busbee and Bynum each had a duty to disclose to the ECUA and to investors but does not plead facts that allow clear inferences to be made as to the SEC’s theory of a duty to speak to the ECUA or the materiality of the information to investors.

From the discussion above analyzing government officials and underwriters within the law of fiduciaries, the following approach is suggested. Busbee was a public official and owed a fiduciary duty of loyalty to the ECUA and the public by whom he was

504. See section 8:11.4.
505. See section 8:11.5.
By choosing his own interests over the interests of the beneficiaries of his fiduciary duties, Busbee had a duty to disclose to the ECUA the material information that his vote for underwriter was prejudiced. The nondisclosure, in view of the duty to speak, was a violation of a fiduciary’s duty of loyalty and the equivalent of a fraudulent misrepresentation. Bynum was an underwriter and had no fiduciary relationship to the ECUA. The duty to speak was therefore owed by Busbee, the public official, not Bynum. Bynum, however, can be viewed as a person causing Busbee to engage in fraud or a person aiding Busbee in the commission of a fraud. A person is subject to the SEC’s full arsenal of remedies as an aider and abettor despite the Supreme Court’s decision in Central Bank precluding the application of implied liability under the antifraud rules to aiders and abettors in private litigation.

In chapter 13, the securities law requirement that the fraud be “in connection with” the purchase or sale of a security is discussed in relation to the Busbee/Bynum facts. There it is concluded that the nexus to a purchase or sale of a security is fully satisfied by the purchase of the ECUA bonds by Stephens Inc. as underwriter. It is unnecessary to make the further linkage to the sale of the securities to investors. The SEC’s attempt to plead that Busbee and Bynum owed a disclosure duty to investors is a tenuous argument that simply detracts from the careful analysis required to establish a fiduciary duty owed by Busbee and implicating Bynum.

**§ 8:11.6 Brokers and Dealers**

Cochran makes much of the fact that Cochran brokered the investment of bond proceeds, was therefore an agent of the issuers, and, as an agent had a fiduciary duty to its principal, each issuer, to disclose fees received by the agent in connection with the investments. The 1934 Act defines a “broker” as any person engaged in the business of effecting transactions in securities for the account of others, and a “dealer” as any person engaged in the business of buying and selling securities for its own account.

506. United States v. Mandel, 591 F.2d 1347, 1363 (1979): “So far as relevant in this case, the Governor of the State of Maryland is trustee for the citizens and the State of Maryland and thus owes the normal fiduciary duties of a trustee, e.g., honesty and loyalty.”

507. Restatement (Second) of Torts § 551.

508. See section 8:3.2.


510. See section 13:3.3[B].


512. See discussion above at section 8:11.5[B].

513. See 1934 Act at §§ 3[a](4) and 3[a](5).
The Second Circuit considered the extent of a broker’s fiduciary duty in Kwiatkowski v. Bear, Stearns & Co., Inc. The case was on appeal from a damage award of $164.5 million against Bear Stearns for failure to provide ongoing advice and failure to provide risk warnings on an ongoing basis in connection with plaintiff’s currency trading. The Second Circuit reversed in an opinion that included extensive discussion of a broker’s obligation to customers who have established a nondiscretionary account with the firm.

In a five-month period, Kwiatkowski made and lost hundreds of millions of dollars betting on the U.S. dollar by trading currency futures. At one point, his positions accounted for 30% of the total open interest in certain currencies on the Chicago Mercantile Exchange. After early gains, he suffered continued losses and contended that Bear Stearns, his brokerage firm, failed to warn him of risks, failed to keep him apprised of certain market forecasts, and gave him negligent advice on the timing of trades. The account at Bear Stearns was a nondiscretionary account, meaning that all trades required the customer’s authorization. In denying Bear Stearns’ motion for judgment, the district court had ruled that the unique facts and circumstances of the parties’ relationship permitted the jury reasonably to find that Bear Stearns undertook to provide Kwiatkowski with services beyond those that are usual for nondiscretionary accounts, and that there was sufficient evidence to find that Bear Stearns provided those services negligently. On appeal, Bear Stearns argued:

1. that as a matter of law, because the account was nondiscretionary, the firm had no ongoing duty to provide information and advice,

2. that the firm did not undertake to provide ongoing and account-monitoring services, and

3. that the firm was not negligent in performing the services it did provide.

The Second Circuit’s summary of a broker’s obligation to customers having nondiscretionary accounts is straightforward:

It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker’s duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer’s investments. A nondiscretionary customer by definition keeps control over the account and has full responsibility for

514. Docket No. 01-7112 (2d Cir. Sept. 19, 2002).
trading decisions. On a transaction-by-transaction basis, the broker owes duties of diligence and competence in executing the client’s trade orders, and is obliged to give honest and complete information when recommending a purchase or sale.\textsuperscript{515}

The Second Circuit found that, with a nondiscretionary customer, a relationship of principal and agent exists only when an order to buy or sell is placed and is terminated when the transaction is complete.\textsuperscript{516} The existence of a broad fiduciary duty depends on whether the broker has “practical control” of the customer’s account.\textsuperscript{517} The district court, however, had determined that Bear Stearns had assumed substantial advisory functions and departed from the usual rules of a nondiscretionary account thereby changing the relationship. The Second Circuit disagreed, holding that there was insufficient evidence to support a finding that Bear Stearns undertook any role triggering a duty to volunteer advice and warnings between transactions.

But the giving of advice is an unexceptional feature of the broker-client relationship. What little case law there is on the subject makes clear that giving advice on particular occasions does not alter the character of the relationship by triggering an ongoing duty to advise in the future (or between transactions) or to monitor all data potentially relevant to a customer’s investment.\textsuperscript{518}

The Second Circuit’s opinion in Kwiatkowski serves as a caveat to the generalization in Cochran 2 that a broker is obligated to act with the utmost good faith toward the principal and to make full disclosure of all material facts that are material to the matter related to the employment. As Cochran 2 reasoned, the disclosure extends to “all material facts within the scope of the agency.”\textsuperscript{519} When an underwriter (like a broker of a nondiscretionary account) engages in conduct that triggers an agency relationship with an issuer, the obligation to make full disclosure extends only to the scope of the agency as determined by the facts of a particular transaction. In addition, as in Kwiatkowski, rendering advice is a customary function of underwriting, and, by itself, should not ordinarily be a trigger for an agency relationship.

\begin{itemize}
\item \textsuperscript{515} Id. (citing, e.g., Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 [2d Cir. 1999] [broker’s fiduciary duty is limited to the “narrow task of consummating the transaction requested”]).
\item \textsuperscript{516} Id. (citing Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 111 [N.D. Ala. 1971]).
\item \textsuperscript{517} Id. (citing Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 516–17 [Colo. 1986]).
\item \textsuperscript{518} Id.
\item \textsuperscript{519} Supra, text at note 498.
\end{itemize}
There must be additional facts, as in Cochran 2, where the issuers implicitly appointed Cochran to act on their behalf in brokering investment contracts.

In holding that Cochran had assumed an agency relationship with the issuers in Cochran 2, the Tenth Circuit cited SEC v. Rauscher Pierce Refsnes, Inc., a yield burning case. Rauscher involved certificates of participation (COPs) issued by the Department of Administration (DOA) of the State of Arizona to advance refund previously issued COPs. Rauscher was appointed financial advisor, and, in that capacity, the firm advised the DOA on the financing and assigned itself the responsibility of selling to the DOA certain U.S. treasury obligations to be held in the escrow. The refunding bonds were yield restricted, and Rauscher allegedly had to burn yield to lower the interest rate on the acquired securities for arbitrage purposes. The SEC alleged that the markup realized by Rauscher was higher than would be the case if there were no yield burning. The amount of the profit was not disclosed to the DOA, and the SEC argued there was a breach of fiduciary duty.

In the ordinary course, a government securities dealer is in a principal-to-principal relationship with the person to whom it sells government securities and therefore not a fiduciary with a duty to disclose all material facts. Rauscher, however, was the financial advisor to the DOA, an agent-principal relationship during the period it was acting as a dealer selling U.S. treasuries. The court, in denying Rauscher’s motion to dismiss, held there was a fiduciary duty of the financial advisor to disclose the profit.

The SEC and Rauscher sharply disagreed on the interpretation of the financial advisory contract and whether it was drafted to create a fiduciary relationship. The court concluded the SEC alleged sufficient facts supporting its theory of the contract to deny a motion to dismiss. Rauscher next attempted to separate the financial advisor role from the government securities dealer role, arguing that the financial advisory relationship ended and the sale of government securities was an entirely separate transaction. The court, however, reasoned that even if the transactions were separate, Rauscher in its role as financial advisor may have been required to disclose that Rauscher as government securities dealer would be acting as a principal and, additionally, that Rauscher as financial advisor, knowing the profit Rauscher as government dealer was receiving, had a duty to disclose the markup.

The line of cases considered above, including Cochran 1, Cochran 2, Kwiatkowski, and Rauscher suggest that an investment banking firm’s


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status in a transaction may change. A firm may begin in an arm’s-length relationship as principal to principal but engage in conduct that makes it reasonable for the other party to believe the firm has become its agents. Likewise, a fiduciary relationship can end and a principal-to-principal relationship commence, or, the fiduciary relationship may be deemed to continue despite the existence of dealer activity that customarily does not involve a fiduciary relationship. The practical implication is that the parties should contractually clarify the status of the firm and whether it will change during the course of a transaction.

§ 8:11.7 Half-Truths and Misleading Nondisclosures

Fiduciary fraud is an exception to the general rule that a person is ordinarily entitled to remain silent despite possessing information that would be material to another. If a person is in a “fiduciary or other similar relation of trust and confidence”\(^{521}\) there is a duty to disclose the material facts, and failure to make the disclosure is fraud. Despite the commonplace reference to a fiduciary duty as the exception to the general rule permitting silence, a fiduciary relationship is but one of five exceptions to the general rule listed in the Restatement of Torts.\(^{522}\)

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521. Restatement (Second) of Torts § 551. United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991), cert. denied, 503 U.S. 1004 (1992) referred to a “similar relation of trust and confidence” as a relationship characterized by “reliance and de facto control and domination” or “confidence” on one side and . . . “resulting superiority and influence on the other.”

522. The following exceptions are listed in Restatement (Second) of Torts § 551:

[2] One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,

(a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; and

(b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and

(c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so; and

(d) the falsity of a representation not made with the expectation that it would be acted upon, if he subsequently learns that the other is about to act in reliance upon it in a transaction with him; and

(e) facts basic to the transaction, if he 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.

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For example, the well-known principle of securities law obligating a person to correct a statement in a disclosure document believed to be true when made but subsequently discovered to be untrue is an application of the third exception to the general rule entitling a person in possession of material information to remain silent as set forth in the Restatement of Torts.

The second exception relates to half-truths or nondisclosures that are closer to a misleading statement than a permitted nondisclosure. A statement that is partial or incomplete may be a misrepresentation because it is misleading when it purports to tell the whole truth and does not. Likewise, a statement made so ambiguously that it is susceptible of two interpretations, one of which is false, creates a duty to disclose the additional information necessary to prevent it from misleading the recipient. For example, B owns a music shop and overhears customer A, wondering aloud to a friend whether a particular violin is a Stradivarius. B approaches and states, “You have excellent taste. This instrument was owned by C, a famous violinist well-known for concert performances on a Stradivarius.” The violin is not a Stradivarius and is worth only $100. B offers the violin to A for several thousand dollars. This statement is sufficiently ambiguous to be misleading regardless of the violin actually being owned by C, the famous violinist. The half-truth requires a further statement. If B had remained silent, the nondisclosure would probably have not resulted in a liability.

When a statement contains a half-truth [a correct statement coupled with a material omission], and the entire statement is rendered misleading by the half-truth, it is unnecessary for the plaintiff, the SEC or the Justice Department to establish that the defendant owed a fiduciary duty to the plaintiff. There is a

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523. See section 6:3.2.
524. RESTATEMENT (SECOND) OF TORTS § 529:
A representation stating the truth so far as it goes but which the maker knows or believes to be materially misleading because of his failure to state additional or qualifying matter is a fraudulent misrepresentation.
525. RESTATEMENT (SECOND) OF TORTS § 527:
A representation that the maker knows to be capable of two interpretations, one of which he knows to be false and the other true is fraudulent if it is made:
[a] with the intention that it be understood in the sense in which it is false, or
[b] without any belief or expectation as to how it will be understood, or
[c] with reckless indifference as to how it will be understood.
526. See section 8:11.2.
misrepresentation, and the defendant is liable, not because of a special
duty to the plaintiff resulting from a position of trust, but because of a
general duty to others not to make misleading statements.\footnote{527}

The Government’s Brief on appeal to the Tenth Circuit in Cochran 1
argues that the duty to speak under the mail and wire fraud statutes is
not limited to a fiduciary duty but may also be found in the duty to
prevent another person from being misled by the “half truths” con-
tained in the statements made.\footnote{528} “A half truth, or what is usually the
same thing, a misleading omission, is actionable as fraud, including
mail fraud if the mails are used to further it, if it is intended to induce a
false belief and resulting action to the advantage of the misleader and
the disadvantage of the misled.”\footnote{529} The misleading omission theory is
derived from the second exception to the general rule of the Restate-
ment of Torts that a person is ordinarily entitled to remain silent
despite possessing material information.\footnote{530}

The misleading omission argument is also the major thrust of the
SEC’s amicus brief in Cochran 1:

The jury was presented with evidence that Cochran actively
misled the issuers regarding the secret fees it was receiving. In
the case of SSM, Cochran and his assistant executed a broker
certificate stating that no fees would be paid other than those
stipulated in the forward supply contract. That statement was
false.

In the Airport Trust offering, Cochran mislead the Airport Trust by
cause Garrett to represent to the issuer that Pacific Matrix had
secured a bid of 6.5% long term and 3.95% short term for the
reinvestment of the proceeds. In fact, Postipankki had bid 7.00%
and 4.2% respectively. Only after Cochran had deducted Stifel’s
kickback was the “bid” 6.5% and 3.95%. The omission of that
“commission” made the statement that Postipankki had bid 6.5%
and 3.95% misleading, if not false.\footnote{531}

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\footnote{528} Brief of Plaintiff-Appellee, No. 96-6305 [Oct. 1996] “nondisclosure
coupled with affirmative misstatements of fact can also constitute a wire
fraud . . .” at 29.
\footnote{529} Emery v. Am. Gen. Fin., Inc., 71 F.3d 1343, 1347 [7th Cir. 1995].
\footnote{530} \textit{Supra} note 522.
\footnote{531} Brief of SEC, amicus curiae, No. 96-6305 [Oct. 1996] at 12–13. Among the
cases cited by the SEC in its brief are United States v. Allen, 554 F.2d 398,
410 [10th Cir.], \textit{cert. denied}, 434 U.S. 836 [1977] (“fraudulent representa-
tions, as the term is used in [the mail fraud statute] may be affected by
deceitful statements of half-truths or the concealment of material facts.”);
United States v. Keplinger, 776 F.2d 678, 698 [7th Cir. 1985], \textit{cert. denied},
§ 8:11.8 Nonfiduciary Obligations Among Participants

The complex structures in public financings require difficult judgments by each of the participants. If the integrity of raising capital for public corporations by maintaining investor confidence is to be assured, each market participant must also have confidence in the quality of information provided by the other participants.

Much of the discussion in the preceding subsections has been concerned with misleading statements or nondisclosures to issuers of municipal securities. The analysis may be extended to circumstances in which other participants in a financing are defrauded. For example, the tax analysis made by bond counsel to render an opinion that interest on municipal bonds is not included in gross income under the Internal Revenue Code of 1986, as amended, is highly dependent on factual information provided to bond counsel by the issuer and consultants acting on behalf of the issuer. If there is a misrepresentation or nondisclosure of material information by the issuer to bond counsel, the SEC has raised the possibility that there may be disclosure fraud because of failure of the issuer to provide investors with information regarding the tax analysis.\(^{532}\) The analysis may be more straightforward, however, if the person to whom the disclosure is owed, and therefore the person defrauded, is viewed as bond counsel rather than the investor. This approach avoids the difficult issues associated with viewing the reasoning of a legal opinion as material information.\(^{533}\)

There are two objections that might be raised in an enforcement action or criminal proceeding to a strategy in which the defrauded

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476 U.S. 1183 (1986) (“fraud can be effected not only by deceitful statements but also by statements of half-truths or concealment of material facts.”); United States v. Romano, 736 F.2d 1432, 1439 [11th Cir. 1984] (“Fraud may be accomplished by willful concealment or omission of material facts, or by intentional statements of half-truths.”); United States v. O’Boyle, 680 F.2d 34, 36 [6th Cir. 1982] (“A false or fraudulent representation . . . may be made by statements of half truths or the concealment of material facts, as well as by affirmative statements or acts.”); United States v. Townley, 665 F.2d 579, 585 [5th Cir., cert. denied, 456 U.S. 1010 [1982] (“under the mail fraud statute, it is . . . unlawful to speak half truths or to omit to state facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading”); United States v. Beecroft, 608 F.2d 753, 757 [9th Cir. 1979] (“Deceitful statements of half-truths or the concealment of material facts is actual fraud under the [mail fraud] statute.”).\(^{532}\)


See section 13:3.2[B].
person is considered bond counsel rather than the investor. The first is that bond counsel is neither a purchaser nor a seller of securities, and bond counsel would itself therefore be precluded from bringing a civil action against the issuer or its agents. The purchaser-seller limitation developed by the courts to limit the universe of plaintiffs in civil actions does not limit an enforcement action by the SEC or a Justice Department criminal proceeding where the policy reasons for controlling the volume of litigation are not present. Rule 10b-5 under the 1934 Act does not literally require the defrauded person to be a purchaser or seller of securities. The operative language is that the fraud be "in connection with the purchase or sale of any security." The issue is the proximity of the fraudulent statement or act to a securities transaction, and since the preparation of a bond counsel opinion is integral to the underwriting of municipal securities, the proximity test would appear to be satisfied.

A second objection to shifting the analysis of the person defrauded from investors to bond counsel (or another market participant) is the requirement to show a duty to speak in a nondisclosure case as discussed throughout this section. When an issuer is making statements to investors, as in the case of an official statement accompanying an offering of municipal securities, there is a duty not to make material misstatements or to omit to state material facts necessary in order to make the statements made, not misleading. If the person allegedly defrauded is a person other than investors, the duty to speak issue resurfaces. The most prominent basis for finding a duty to speak in a nondisclosure case is to establish a fiduciary relationship, but an issuer and its agents do not owe fiduciary duties to bond counsel. However, a fiduciary relationship is but one of several bases for requiring a person to make material disclosures at the risk of silence constituting fraud.

Section 551(2) of the Restatement of Torts lists five circumstances in which there is a duty to speak trumping the general right to remain silent and make no disclosure. The first is the existence of a fiduciary duty or other similar relation of trust and confidence. This finding is the basis of fiduciary fraud as discussed in this section and is unlikely to be available in the case of nondisclosure of material information relevant to bond counsel’s tax analysis. However, depending on the circumstances, each of the exceptions in section 551(2)[b] through [e] could be applied to the information forming the basis of

534. See section 8:3.1.
535. See discussion at section 8:3.2.
536. See section 8:11.2.
537. See discussion at section 8:4.
538. Supra note 522.
bond counsel’s tax opinion. For example, section 551(2)(b) refers to half truths and misleading nondisclosures that were discussed in the government’s brief on appeal to the Tenth Circuit in Cochran 1539 and in the amicus brief of the SEC 540. The nondisclosure of material tax information to bond counsel is likely to be made in the context of other disclosures. In the usual course of bond counsel tax due diligence, the tax lawyers will ask numerous questions depending on the complexity of the tax issues involved. If the issuer or its agents knowingly withhold material information in the context of providing other information to bond counsel, the omission could be viewed as misleading. Likewise, section 551(2)(e) of the Restatement of Torts disallows withholding “facts basic to the transaction.” Bond counsel is engaged by an issuer to render an opinion on the validity of the bonds being issued and the tax-exempt status of the bonds. To render the tax opinion, bond counsel will ordinarily require factual information from the issuer. For example, in rendering an opinion in connection with an airport financing it is necessary for bond counsel in preparing a tax opinion to establish the public use of the facilities being financed. If officials of an airport authority knowingly withhold from bond counsel that a substantial portion of bond proceeds will be diverted to private use and further know that bond counsel is mistakenly relying on public use as a basic fact in rendering an opinion, the issuer’s silence may be held to be fraudulent despite the general rule supporting the right to silence even while in possession of material information.541

§ 8:12  Markup Fraud: Yield Burning

Throughout this chapter, fraud concepts have been applied to securities transactions that are unique to public finance. The discussion above should make apparent that structural aspects of public finance frequently preclude a facile analysis of securities law. This difficulty continues when the law of excessive markups is applied to the structuring of escrow funds in an advance refunding of municipal securities. The requirements of the Internal Revenue Code of 1986, as amended (Code), and the arbitrage regulations542 of the Internal

539.  See section 8:11.7.
540.  Section 8:11.7 at note 531.
541.  For a discussion of the relation between the general rule allowing nondisclosure set forth in Restatement (Second) of Torts § 551(1) and circumstances in which nondisclosure of basic facts may result in a requirement of disclosure, see Restatement (Second) of Torts § 551, comment on subsection [2].
542.  The term “arbitrage regulations” is used in this section to refer to the arbitrage provisions of § 149 of the Code and the applicable IRS regulations appearing under I.R.C. §§ 103, 148, 149, 150.
Revenue Service (IRS) promulgated under the Code, which the issuer must follow for interest on the refunding bonds to be exempt from income taxes, complicate the application of fraud concepts under the securities laws.

A state or political subdivision issues refunding bonds to provide funds to repay the principal or redemption price of and interest on the refunded bonds. A “high-to-low” interest rate refunding is issued in order to provide savings in debt service, and a “low-to-high” refunding may be issued to restructure debt service to conform to the timing of revenues or to discharge existing covenants protecting the holders of the refunded bonds. In either form, the refunded bondholders are likely to have call protections that may preclude immediate application of the proceeds of the refunding bonds to the repayment of the refunded bonds; that is, at the time of issuance of the refunding bonds, the refunded bonds may not yet be subject to redemption. In this case, the issuer deposits the proceeds of the refunding bonds in an escrow fund held by a corporate trustee and invests the proceeds in government securities until the refunded bonds are redeemable. The arbitrage differential between the lower-rate, tax-exempt refunding bonds and the higher-rate, taxable government securities in high-to-low refundings could encourage issuers to refund repeatedly if it were not for restrictions under the arbitrage regulations. For the IRS, multiple refunding issues for the same capital project are a drain on federal revenues because of the duplicative tax-exempt interest income.

To neutralize the arbitrage benefit, the arbitrage regulations provide that the refunding bond proceeds may not be invested (with certain limited exceptions) in securities having yields higher than the yield on the refunding bonds. If the yield on the government securities is higher than the yield on the refunding bonds, the issuer will be required to take steps to assure that the overall yield on the government securities does not exceed the overall yield on the refunding bonds. One practice is to invest the refunding proceeds in certain U.S. Treasury government securities (referred to as State and Local Government Series, or SLGS), which pay little or, to the extent necessary, no interest, so the overall yield on the government securities equals the yield on the refunding bonds. The economic effect of SLGS is to transfer the arbitrage benefit from the issuer to the federal government. A second technique is to invest and reinvest the refunding bond proceeds in a portfolio of high and low yielding investments, which may include open market government securities, SLGS, or a “float contract,” at a blended yield equal to the yield on the refunding bonds.

The SEC has undertaken an investigation that relates to a third technique that is not permitted under the arbitrage regulations. The broker-dealer selling the government securities could raise the price of the government securities, thus lowering the yield until the yield on
the government securities equals the yield on the refunding bonds. This practice, referred to as “yield burning,” results in the arbitrage benefit being diverted to the broker-dealer. Because yield burning works to the disadvantage of the federal government (by avoiding investments in SLGS), the arbitrage regulations require that any open market investments be made in an arm’s length transaction reflecting fair market value without regard to any amount paid to reduce the yield of those securities (market price rule). If the government securities dealer marks-up the government securities to burn yield to a price that would be viewed as excessive under the securities laws and omits to inform the issuer of the markup, the government securities dealer may be engaging in fraudulent conduct. A markup is excessive if it bears no reasonable relation to the market price. The excessive amount is said to be material information, and the failure to disclose the excessive amount is said to be omitting to state material information in connection with the sale of a security. A complicating factor is that the firm selling the government securities to the issuer for deposit in the escrow fund may also be either the issuer’s financial advisor or the underwriter of the refunding bonds. If the escrow provider is a financial advisor it may have a duty as a fiduciary, depending on the circumstances, to inform the issuer of the amount of the markup.  

If the escrow provider is also the underwriter of the issuer’s municipal securities, the underwriter, as a principal in an arm’s-length relationship, does not have a duty to disclose the markup to the issuer by reason of its role as underwriter, but the underwriter does have a duty of disclosure to investors, and the SEC takes the position that if the firm has knowledge of facts threatening the tax-exempt status of the municipal securities there is a duty of disclosure to investors.  

In April 1998, the SEC settled its first yield-burning enforcement action, In re Meridian Securities, Inc. The respondents, who neither denied nor admitted to any wrongdoing, agreed to pay more than $3.8 million to resolve securities fraud claims, as well as penalties of the IRS and the Justice Department. In the Meridian Order, the SEC found that Meridian Capital acted as underwriter of numerous advance refunding transactions and as escrow provider selling government securities for deposit in the escrow funds. The SEC further found that Stallone, an employee in the public finance

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543. For a discussion of fiduciary fraud, see supra section 8:11 and infra section 12:6.1.
544. See section 8:11.5.
545. See section 13:3.2[B] and text below at note 548.
department underwriting the municipal securities, also selected the
government securities to be sold by the firm for the escrow fund and
determined the prices of the government securities. The markups were
calculated on a portfolio of government securities to burn the yield of
the entire portfolio of government securities down to the yield on the
refunding bonds. Markups were found to range as high as 13.78%.
This procedure was a significant departure from preferable practices in
which the public finance investment banker calls the firm’s govern-
ment securities dealer and asks the price on government securities
over a range of maturities, effectively acting arm’s-length within the
firm. This, or similar practices, allows the firm to certify that the
government securities are sold at the market. The SEC found that
the arbitrage regulations in effect at the time Meridian Capital engaged
in the refunding transactions required that the government securities
be priced at fair market value. Fair market value is defined as the price
at which a willing buyer would purchase the government securities
from a willing seller in a bona-fide arm’s length transaction. The SEC
concluded:

In connection with the sale of Treasury securities to the munici-
palities, Meridian Capital, Stallone and/or another employee of
Meridian Capital also made certain material misrepresentations
and omissions. In 5 instances, they provided documents in the
form of certifications that in essence represented that the prices on
the Treasury securities were at fair market value and established
without an intent to reduce yield. In fact, the prices on the
Treasury securities in those transactions exceeded fair market
value by reason of the mark-ups that were charged, and were
established with an intent to reduce the yield on the Treasury
securities. The municipalities relied upon these representations in
making their certifications that the bonds were not arbitrage
bonds.\(^\text{547}\)

In addition to the material misrepresentations in Meridian Capi-
tal’s market price certifications, the SEC found that the official
statements contained material omissions known to Meridian Capital,
namely, that the fair price certifications were misleading. Investors
should therefore have been warned of the implications of the mislead-
ing tax certificates on the tax-exempt status of the refunding bonds:

As underwriter of various advance refunding bonds, Meridian
Capital had an obligation to have a reasonable basis for belief in
the truthfulness and completeness of the key representations
made in the disclosure documents used in the securities offerings.

\(^{547}\text{ Meridian Order at G.1.}\)
Exch. Act Rel. No. 26100 (Sept. 22, 1988). In addition, employees of Meridian Capital participated in the preparation of those offering documents, and were responsible for various representations contained in those documents. The offering documents did not disclose to potential bond purchasers that Meridian Capital, Stallone and another employee of Meridian Capital had sold the Treasury securities to the municipalities for more than their fair market value by reason of the mark-ups that were charged. Nor did the documents disclose that they did so in order to receive arbitrage profits in those advance refundings and had, thereby, placed the tax-exempt status of the refunding bonds in jeopardy. Therefore, Meridian Capital, Stallone and another employee of Meridian Capital also failed to disclose material facts in the offering documents which were distributed to the bond purchasers in those advance refunding transactions.

§ 8:12.1 The Fair Market Value Rule Under the Arbitrage Regulations

The IRS policy to contain the aggregate amount of outstanding tax-exempt municipal securities in the United States has led to a series of restrictions on advance refundings. For example, the arbitrage regulations favor “current refundings” over advance refundings. In a current refunding, the refunded bonds mature or are redeemed within ninety days of the issuance of the refunding bonds. An advance refunding is defined as a refunding that does not meet the definition of a current refunding. The arbitrage regulations restrict the number of advance refundings permitted a state or political subdivision for the same underlying financing, and prohibit advance refundings that benefit private persons other than non-profit organizations such as hospitals or universities. If the advance refunding results in a present value savings, the refunded bonds must be redeemed on the first call date. Most importantly, the yield on the portion of the escrow fund provided by the proceeds of the refunding bonds is not permitted to be invested at a yield above the aggregate reoffering yield of the refunding bonds.

In order to prevent yield burning, the arbitrage regulations have required that government securities deposited in the escrow fund may not be purchased at a price higher than a fair market value purchase price. There is an exception for securities “purchased directly from

549. Treas. Reg. § 1.150-1[d][3] and [4].
550. I.R.C. § 149[d][3].
551. I.R.C. § 149[d][2].
552. I.R.C. § 149[d][3][A].
553. Treas. Reg. § 1.148-5[b][2][iv].
554. Treas. Reg. § 1.148-6[c].
the United States Treasury” to encourage the use of SLGS. If the available government security rate is below the rate on the refunding bonds (“negative arbitrage”), issuers are likely to purchase open market government securities because the SLG rate is not permitted to be higher than 0.05% below the market rate. Yield burning issues come into play when issuers purchase open market securities under circumstance in which the market rate on the government securities is higher than the rate on the refunding bonds, and the SLGS could have been purchased without any resulting negative arbitrage. If the issuer chooses to purchase open market securities rather than SLGS, they must be purchased at a fair market value.

Fair market value is defined generally as the price a willing buyer would pay a willing seller in a bona fide arm’s-length transaction. To establish that escrow fund securities (other than SLGS) were purchased at fair market value, bond counsel have frequently required certification at closing of facts that would evidence compliance with the fair market value rule.

In June 1996, the IRS published a revenue procedure establishing a rebuttable presumption that government securities (other than SLGS) were purchased at fair market value. In its background statement, the IRS stated that certifications from providers of government securities were not meaningful evidence of the fair market value of a transaction. The rebuttable presumption would require the issuer to

1. conduct a good faith solicitation for the purchase of government securities from reasonably competitive bidders,

2. receive at least three bona fide bids from providers having no financial interest in the issuer (thereby excluding underwriters and financial advisors), and

3. accept the highest-yielding bid.

In addition, the yield on the government securities purchased must not be significantly less (that is, price must not be significantly higher) than the yield then available from the provider on reasonably comparable government securities and at reasonably comparable terms offered to persons other than the issuer or the trustee holding the proceeds of tax-exempt municipal securities. A certificate by the bidding agent would be acceptable to establish comparability.

The 1996 revenue procedure also announced a “closing agreement program” by which issuers could enter into voluntary closing agreements.
agreements to make payments to the IRS to preserve the tax-exempt status of the refunding bonds in circumstances where escrow funds previously established by the issuer involved payment of above-market prices for open market government securities. The IRS stated it will not accept anything more than an “insubstantial” markup. In general, the IRS view of the appropriate payment to the IRS under the voluntary program would be the excess of the amount paid over the next day delivery “spot price” for the government securities. The closing agreement program was announced in the context of ongoing investigations into yield burning practices by the IRS, the Justice Department, and the SEC.

§ 8:12.2 Misrepresentations in Fair Market Value Certificates

In January 1998, the SEC commenced a civil injunctive action in the U.S. District Court in Arizona against Rauscher Pierce Refsnes Inc. and a former employee, James Fletham, alleging that the defendants had defrauded the Arizona Department of Administration (state) in connection with a 1992 refunding transaction, for which Rauscher served as financial advisor, by selling government securities to the state at above-market prices without proper disclosure. The amended complaint alleged fraud under section 17(a) of the 1933 Act, section 10(b) of the 1934 Act, and sections 206(1), (2), and (3) of the Advisers Act. The Rauscher Complaint pleaded both misrepresentation and omission theories of fraud. The misrepresentation theory is based on statements made by Rauscher in its fair market value certification delivered at closing pursuant to the arbitrage regulations in effect in 1992.

The Rauscher Complaint states that the fair market value certificate signed by Rauscher and delivered at closing (Certificate) falsely represented that Rauscher sold the government securities “at a price that was equal to [their] fair market value.” The arbitrage regulations in effect in June 1992 required that the yield on open market government securities must be calculated on the “market price.” Market price was defined as the mean between the bid and offered prices published by appropriate publications on an established market or the actual price paid if the government securities were purchased in an arm’s-length transaction without regard to any amount paid to reduce yield. The Rauscher Complaint charges

560. Rauscher Complaint, ¶ 32.
that the Certificate did not satisfy either test and was therefore false and misleading.

The Motion to Dismiss Memorandum filed by Rauscher cites contemporaneous interpretations of the arbitrage regulations to argue that, given the risks inherent in a forward delivery of government securities as referenced in the Certificate, the fair market price was likely to be a range of prices rather than a precise figure such as the mean of the bid and offered prices.\textsuperscript{562} The Bond Market Association filed an amicus curiae brief supporting defendants' view of contemporaneous interpretations of the arbitrage regulations concluding that:

\begin{quote}
The SEC has failed adequately to plead that any allegedly false statements were made with scienter in the absence of any allegations that Rauscher's behavior was inconsistent with the contemporaneous understanding of underwriters and bond counsel with respect to the meaning of those regulations. Appropriate markups are customary and \textit{expected} in arm's-length escrow transactions. When markups do not violate the securities laws—and thus do not exceed what could have been charged in a bond fide arm's length transaction—there is no reason why a security should be deemed not to have been sold at "fair market value" under relevant Treasury regulations.\textsuperscript{563}
\end{quote}

The Bond Market Association argued that fair market valuation under the arbitrage regulations should take into consideration the facts and circumstances of each particular refunding rather than rigidly referencing spot pricing to establish fair market value. The facts and circumstances typical of advance refundings are detailed in the Bond Market Association Brief:

\begin{quote}
Securities sales for advance refunding escrows, which are individually tailored transactions, are entirely different from straight Treasury trades for regular-way settlement. Among other things, dealers who price and sell securities for a refunding escrow frequently perform specialized functions that go beyond those provided by dealers in the "spot" market and that may add substantial value to a transaction. These include working with an issuer and other transaction participants to assemble and price a package of securities with different maturities and attributes that
\end{quote}

\textsuperscript{562.} SEC v. Rauscher Pierce Refsnes, Inc., James R. Feltham & Dain Rauscher, Inc., Memorandum in Support of Motion to Dismiss of Rauscher Pierce Refsnes, Inc. and Dain Rauscher Incorporated [Mar. 31, 1998] [Motion to Dismiss Memorandum].

precisely defease a prior issue of securities, frequently under considerable market constraints and pursuant to specific pricing and review requirements established by the issuer; keeping an offer open at constant prices for a “hold firm” period to allow the issuer to make adjustments to the escrow package on the trade date . . .

Dealers who perform such functions for forward settlement in an advance refunding escrow also incur significant risks beyond those effecting instantaneous sales of individual Treasury securities for next-day settlement. These risks—including the risk of market price volatility during the “hold firm” period, the risk that a verbal award for the bond issue may be revoked, and the risk that the transaction will not close—would normally affect the dealer’s pricing of the escrow package, as would the costs of appropriate hedging transactions to the extent such risks can be hedged. The SEC’s own exhibits reveal that Rauscher for example faced significant risks of the transaction not closing, leaving it in possession of the escrow securities and subject to the risk of market movements on their value as well as on any positions it acquired to hedge its delivery obligations. . . . This is critical because the SEC’s markup precedents—even if they supported the SEC’s position here—are by their terms directed to transactions in which the dealers acted as “riskless principals.”

Finally, contrary to the SEC’s contention, the securities generally sold by dealers for advance refunding are not the “most liquid . . . in the world . . . freely traded in enormous volumes daily . . . .” Rather, the need for dealers to match precisely payment dates on the defeased bonds generally leads to selection of STRIPs and “off-the-run” securities, which are the most illiquid securities in the Treasury market. See Compl. ¶ 20 (most of Rauscher’s sales were Treasury STRIPs).

In a misrepresentation case the issue is not whether the government dealer firm should take these risks into consideration in pricing the government securities. The issue is whether the Certificate was materially false and misleading in stating that “such price was no higher than the price that Rauscher would have charged any other customer purchasing the Open Market Securities under similar circumstances in a transaction in which the yield on the Open Market Securities was not subject to any limitations . . . .” If Rauscher would have charged other customers (such as private utilities not subject to yield restrictions engaged in advance refunding mortgage

565. Motion to Dismiss Memorandum, n.18 quoting Certificate.
bonds) a similar price for the risks incurred and other considerations cited by the Bond Market Association, the Certificate is accurate. Unlike the analysis of “excessiveness,” to be discussed below in considering whether Rauscher had a duty to disclose the markup, the review of the Certificate is limited to determining whether it accurately states the facts. An “excessiveness” inquiry allows the SEC to consider what the price should have been. A misrepresentation inquiry is solely whether the Certificate was materially false and misleading.

The district court denied defendants’ motion to dismiss.566 The court found that the SEC had adequately pleaded three false or misleading statements in the Tax Certification issued by Rauscher at closing and relied upon by bond counsel:

1. Rauscher stated the sale of escrow securities “was an arm’s length transaction” because Rauscher was on both sides of the transaction. The SEC alleged this statement was false because Rauscher was both a fiduciary to DOA recommending the purchase of the securities and the seller of the securities with an undisclosed financial interest.

2. Rauscher stated the escrow securities were priced “without regard to any amount paid to reduce the yield.” The SEC alleged this statement was false because there was a positive arbitrage situation and the securities were priced to burn yield.

3. Rauscher stated the escrow securities were priced “at fair market value.” The SEC contended this statement was false because the price to DOA exceeded “the mean of the bid and offered prices for those securities on an established market.”

In April 2000, the SEC announced its “global resolution” of fraud charges against ten investment banking firms, including Rauscher, in connection with yield burning.568 In anticipation of the cease-and-desist order pursuant to the global resolution, Rauscher submitted an offer of settlement, which the SEC accepted. The effect was to settle the Arizona yield burning case described above.569 In the Rauscher Cease-and-Desist Order, the SEC found that the Tax Certification for the DOA financing was materially false and misleading in that the

568. See section 8:12.3[a].
prices of the escrow securities did not equal the “fair market value,” and the prices were not determined in an “arm's length transaction without regard to any amount paid to reduce the yield on the securities.”

§ 8:12.3 The Dealer’s Duty to Disclose Markups

In addition to the misrepresentation theory charging that Rauscher’s fair market value certificate was materially false and misleading, the Rauscher Complaint charges that Rauscher had a duty to disclose to its client the amount of the markup. Unlike a misrepresentation case in which the defendant has chosen to speak and the issue is whether the defendant has misled, in a non-disclosure case, in which the defendant has chosen not to speak, there is a preliminary issue whether, in fact, the defendant had a duty to speak. The SEC pleaded two distinct theories for arguing that Rauscher had a duty to disclose the markups on the government securities. First, the SEC argued the markups were excessive, and excessive markups require disclosure as a matter of law. Second, the SEC argued that the firm as financial advisor was a fiduciary in possession of information material to the beneficiary of the fiduciary relation and therefore had a duty to speak. Alternatively, the SEC argued that Rauscher acted as an investment adviser to the state with the fiduciary obligations imposed on investment advisers under the Advisers Act.

[A] Excessive Markups

A markup, for sales to customers, is the difference between the price to the customer and the prevailing market price on the sell side of the market. To determine whether a markup is excessive, it is necessary first to decide the appropriate reference to fix the prevailing market price. The markup is then calculated by subtracting the reference market price from the price at which the security is sold to the customer. When the markup is thereby quantified, it can be evaluated under the circumstances of the sale to make a conclusion whether it is excessive. The reference for determining prevailing market price is generally the contemporaneous cost to the dealer. If the dealer is a market maker in an active inter-dealer market, the inter-dealer wholesale market may be a reliable, objective measure, but in its

571. Rauscher Complaint, ¶ 20–22.
572. Rauscher Complaint, ¶ 25.
enforcement experience, the SEC has generally found contemporaneous cost to be the more reliable criterion.\textsuperscript{574}

The standard for determining an excessive markup is whether, based on the facts and circumstances in a given case, the price charged was reasonably related to the prevailing market price.\textsuperscript{575} The SEC alleged in the Rauscher Complaint that the markups were excessive and undisclosed. According to the SEC, an undisclosed, excessive markup creates a duty to speak because it violates the broker-dealer’s implied representation to its customer that the customer will be dealt with fairly.\textsuperscript{576} The theoretical basis for disclosing excessive markups was stated by the SEC as follows:

The duty to disclose excessive markups is based on the “shingle theory”—the principle that when a broker hangs out its professional shingle it implies that it will deal with customers fairly and charge them a fair price . . . The legal standard for determining when a mark-up is excessive has long been whether, based on all of the facts and circumstances in a given case, the price charged was reasonably related to the prevailing market price.\textsuperscript{577}

\textsuperscript{574} In re Alstead, Dempsey & Company, Inc., Exchange Act Release No. 20,825 [Apr. 5, 1984] (“Registrant dominated the market to such a degree that it controlled wholesale prices. Thus the only reliable basis for determining the prevailing market price is the contemporaneous cost the registrant was willing to pay other dealers. . . .”); In re F.B. Horner & Associates, Inc. and Fred B. Horner, Exchange Act Release No. 30,884 [July 2, 1992] (“We have consistently held that where, as in the present case, a dealer is not a marketmaker, the best evidence of the current market, absent countervailing evidence, is the dealer’s contemporaneous cost.”); In re Application of Kevin B. Waide, Exchange Act Release No. 30,561 [Apr. 7, 1992] (“a trade on a riskless principal basis should be treated similarly to an agency transaction, in which the firm may retain no more than a commission computed on the basis of its cost”). The preference for contemporaneous cost was reflected in the NASD’s 1998 proposed rule change for markup policy for transactions in debt securities, which includes government securities but excludes municipal securities: “in the absence of other bona fide evidence of the prevailing market price of a security.” 1M-2440-2, Exchange Act Release No. 40,511, File No. SR-NASD-97-61 [Sept. 30, 1998].

\textsuperscript{575} In the Matter of Sheldon, Reid & Pattison, Exchange Act Release No. 31,457 [Nov. 18, 1992].


For there to be a duty to speak under the implied misrepresentation or “shingle” theory, the markup must be excessive. In determining whether a markup is excessive and not reasonably related to the prevailing market price, the courts consider, among other factors, the industry practice regarding the range of appropriate markups on a particular type of security. Accordingly, markups of 5% for collateralized mortgage obligations have been held to be excessive,\(^{578}\) and markups of 5% for government securities have been found to be excessive,\(^{579}\) indicating that generally the NASD “5%” rule of fair conduct is not available for many debt securities.\(^{580}\) The SEC referenced the “5%” rule in its 1987 release discussing markups of zero coupon securities, including Treasury STRIPS (Zero Coupon Release):

\[\text{[T]he Commission believes that as a general matter, common industry practice regarding mark-ups is to charge a mark-up over the prevailing inter-dealer market price of between 1/32% and 3\(\frac{3}{4}\)% (including minimum charges) for principal sales to customers of conventional or “straight” Treasuries, depending on maturity, order size and availability. In light of this evidence, the Commission concludes that mark-ups on government securities, like mark-ups on corporate and municipal debt securities, usually are smaller than those on equity securities.}\(^{581}\)

The Zero Coupon Release was cited by defendants in \(\text{Press v. Chemical Investment Serv. Corp.}\)^\(^{582}\) in a motion to dismiss plaintiff’s claim that defendants engaged in excessive markups of Treasury bills. In \(\text{Press}\), the markup was 1/6 of one percent. The court granted the motion to dismiss concluding that “excessiveness appears not to even become a consideration in debt security cases until markups reach the 3–3\(\frac{1}{2}\)% percent range.”\(^{583}\) The Rauscher markups ranged between 0.02 and 0.73 of one percent.

The Bond Market Association reviewed the precedents for excessiveness in its amicus brief and reached the following conclusion:

\[\text{In essence, the SEC contends that it can discard decades of judicial and administrative guidance, all of which confirms that Rauscher’s markups are not at and do not even approach questionable levels, through a conclusory allegation that there are}\]

\(^{578}\) F.B. Horner & Assocs. v. SEC, 994 F.2d 61, 63 [2d Cir. 1993] (noting that an average markup on zero coupon collateralized mortgage obligation bonds was 1.8 to 2.9% for dealers providing similar services).

\(^{579}\) In the Matter of Sheldon, et al., supra note 575.

\(^{580}\) \(\text{Banca Cremi, S.A.}\), 132 F.3d 1017, supra note 576 at note 20.


\(^{583}\) \(\text{Id. at 20,430.}\)
“facts and circumstances” in this case which violate a new (and, even now, unarticulated) minimum standard governing markups on Treasury securities. In making this contention, the SEC not only ignores the weight of judicial and administrative precedent establishing that the markups at issue were not excessive, it also misapplies the very principle that it is espousing by attempting to compare the Rauscher transactions to straight trades of U.S. Treasury securities and competitive escrow transactions consummated under market constraints far less onerous than those faced by Rauscher here. Based on the SEC’s own exhibits, a “facts and circumstances” analysis of the transaction at issue would, if anything, justify higher markups here than in either of the other types of transactions to which the SEC alludes.\footnote{584}

The amicus brief of the Bond Market Association follows with a discussion of the considerations in an advance refunding that would justify a markup above the spot price. These paragraphs are quoted above in the review of IRS requirements in the arbitrage regulations for fair market valuation of escrow fund government securities.\footnote{585}

The SEC also recognized that excessiveness depends on the facts and circumstances of specific cases:

In determining whether a markup is excessive, the finder of fact must assess all the relevant facts and circumstances, including the industry practice regarding the range of appropriate markups on a particular security or similar securities in comparable transactions. . . . Other factors which must be assessed include \{1\} the availability of the security, \{2\} the total amount of money involved in the transaction, \{3\} the nature of the broker-dealer’s business and the pattern of its markups, \{4\} the unit price of the security, \{5\} the nature of the services that the brokerage firm provides to the customer and \{6\} and the extent to which the broker-dealer was at risk in the transaction.\footnote{586} 

The facts and circumstances cited by the SEC, however, lead it to conclude that the markup in an advance refunding comparable to the Rauscher facts should result in markups ranging from zero to 0.06%. For example, the services provided by Rauscher in tailoring the government securities to the requirements of the escrow fund would lead the Bond Market Association to conclude that a higher markup is justified, whereas the Rauscher role as financial advisor would lead the SEC to conclude that the markup should be lower. Likewise, the SEC viewed the large dollar volume in Rauscher, when compared to Press, 

\footnotesize{584. Bond Market Association Brief, at 13.}  
\footnotesize{585. See section 8:11.2.}  
\footnotesize{586. SEC Reply Memorandum, at 22.}
as requiring a smaller percentage markup than would be justified in Press. The SEC further contends that the Press district court misread the precedents and therefore defendants’ reliance on Press is misplaced:

Defendants have adopted the Press court’s misinterpretation of the Zero-Coupon Securities release. Following the lead of the Press court, defendants contend that in that release the Commission concluded that any markup on Treasury securities within the range of 1/32% to 3 1/2% was “acceptable.” This argument is based on a misreading of the Zero-Coupon Securities release. In that release, the Commission observed that the common industry practice regarding mark-ups is to charge . . . between 1/32% and 3 1/2% (including minimum charges) for principal sales to customers of conventional or ‘straight’ Treasuries, depending on maturity, order size and availability. . . . In the context of the markup principles discussed above, it is clear that this statement did not mean that in order to be found excessive a markup on a transaction in Treasury securities must exceed 3.5%. Rather, the Commission observed that the standard industry markup on a particular transaction in Treasury securities might be anywhere from 1/32% to 3 1/2% “depending on maturity, order size and availability.” Id. [emphasis added]. Indeed, the Commission’s release recognizes that in some circumstances, markups no greater than 1/32% may be appropriate. Accordingly, defendants’ argument that the markups at issue in this case are “at the extreme low end of what the SEC has previously considered acceptable” (Rauscher Mem. at p.10) is seriously flawed. Instead, the markups at issue in this case (which average.55%) are more than 18 times greater than 1/32 (or.03%), which is the low end of the range cited in the Zero-Coupon Securities release. 587

The Rauscher court denied the motion to dismiss because the complexity of the transaction precluded a finding that the markups were either excessive or not excessive as a matter of law. 588 The court summarized the legal analysis resulting in a duty to disclose an excessive markup as follows:

There can be no question that broker-dealers have an obligation under federal securities laws to disclose markups that may be deemed excessive. This duty arises because there is an implied representation by broker-dealers when they hang out their shingle to do business that they are charging their customers securities prices that are reasonably related to the prices charged in an open and competitive market. Broker-dealers that do not disclose that

they are charging excessive markups are committing fraud. Thus, Defendants had a duty to disclose their markup only if it was excessive.\textsuperscript{589}

The duty to disclose a markup to a customer when it is excessive, which is based on the shingle theory, is a distinct duty separate from the obligation of a fiduciary to disclose material facts related to the scope of the employment as discussed below. The shingle theory duty to speak is triggered by the excessiveness of the markup.

The Rauscher Cease-and-Desist Order, in settlement of the Rauscher case, contained the SEC's finding that the markups Rauscher charged on the escrow securities, averaging approximately 0.55\% (or just over one half of one percent), were not reasonably related to the prevailing market prices. Accordingly, Rauscher was found to have violated section 10(b) of the 1934 Act and Rule 10b-5 thereunder, section 17(a) of the 1933 Act, and sections 206(1) and 206(2) of the Advisers Act. As to scienter, required by Rule 10b-5, the SEC concluded "Rauscher knew, was reckless with respect to whether, or should have known that the prices it charged DOA were not reasonably related to the prevailing wholesale market prices of the securities."\textsuperscript{590}

\textbf{[B] Fiduciary Relationship}

In addition to the SEC's argument that excessive markups, as a matter of law, gave rise to a duty to speak, the SEC charged that Rauscher was in a fiduciary relationship with its client, and that the duty of loyalty imposed on fiduciaries required disclosure of the markups.\textsuperscript{591} The fiduciary relationship was found by the SEC to emanate from the contractual relation with the state appointing Rauscher as financial advisor in connection with the state's issuance of municipal securities.\textsuperscript{592} The SEC recognized that not every financial advisory contract gives rise to a fiduciary relationship and accordingly pleaded facts to establish the reliance and trust placed in Rauscher by personnel of the state.\textsuperscript{593} Alternatively, the SEC argued that the advice provided by Rauscher in structuring the escrow fund resulted in

\textsuperscript{589} 17 F. Supp. 2d 985, 996–97 [citations omitted].
\textsuperscript{590} Rauscher Cease-and-Desist Order.
\textsuperscript{591} Rauscher Complaint, ¶ 25.
\textsuperscript{592} Rauscher Complaint, ¶ 13.
\textsuperscript{593} Rauscher Complaint, ¶ 25. The defendant disputed the conclusion that the financial advisory contract resulted in a fiduciary relationship because the contract, by its terms, rejected an agency relationship. Rauscher Motion to Dismiss, at 17. For a discussion of financial advisors as fiduciaries, see section 12:6.1.
Rauscher becoming an investment adviser with fiduciary duties dictated by the Advisers Act.\footnote{Rauscher Complaint, ¶ 27.}

The issue raised by the Rauscher facts is whether the financial advisor relationship of the Rauscher public finance department to the state is superimposed on the government securities desk at Rauscher when it is acting as a dealer in selling government securities for deposit in the escrow fund. A government securities dealer ordinarily acts as a principal in transactions with customers, and the principal relationship is stated on the confirmation. SEC Rule 10b-10 regulating confirmations, including confirmations in the sale of government securities, requires disclosure of compensation in agency transactions and in certain principal transactions involving equity securities, but the confirmation disclosure on debt securities is limited to the dollar price of the transaction and a calculation of yield.\footnote{SEC Rule 10b-10 regulating confirmations, including confirmations in the sale of government securities, requires disclosure of compensation in agency transactions and in certain principal transactions involving equity securities, but the confirmation disclosure on debt securities is limited to the dollar price of the transaction and a calculation of yield.} On three occasions the SEC had proposed amendments to Rule 10b-10 that would have required confirmation disclosure of markups in riskless principal transactions.\footnote{On three occasions the SEC had proposed amendments to Rule 10b-10 that would have required confirmation disclosure of markups in riskless principal transactions.} In each case the proposals were rescinded in light of comment from the industry that, among other factors, the markup was not material; material information is the yield.\footnote{In each case the proposals were rescinded in light of comment from the industry that, among other factors, the markup was not material; material information is the yield.} The failure of the rulemaking process to achieve a workable rule to regulate markup disclosure of riskless principal transactions has been cited as casting doubt on the ability of the SEC to impose dealer markup disclosure in principal transactions by enforcement proceedings.\footnote{The failure of the rulemaking process to achieve a workable rule to regulate markup disclosure of riskless principal transactions has been cited as casting doubt on the ability of the SEC to impose dealer markup disclosure in principal transactions by enforcement proceedings.}

In complex investment banking firms, the public finance department and the government securities desk view themselves as virtually distinct entities. The separation of departments rests in part on “chinese wall” policies and procedures to prevent the flow of confidential and proprietary information from persons engaged in investment banking and other advisory activities from those engaged in sales, trading, and research activities. The reality of investment banking practice is that bankers may be in an agency relation with a corporate or municipal client advising it on transactions while the sales and trading desks are engaged in purchases and sales of debt securities with the same corporation or municipality on a principal to principal basis. The agency relation of one part of the firm does not destroy the principal relation of another part of the firm.

The distinction between this ordinary course of business conduct and an advance refunding is that in an advance refunding, the sale of
government securities by the government securities desk relates to the same municipal securities transaction (the refunding bonds) being underwritten by the public finance department. In Meridian Securities, the public finance employee acting as underwriter also priced the government securities. In the more customary circumstance, the public finance investment banker, whether underwriter or financial advisor, calls the government securities desk at the request of the issuer and obtains prices on various government securities. The question is whether this contact is enough for the government securities desk to be legally impacted by the investment banker’s relationship with a client. The Rauscher Complaint pleaded that the written financial advisory contract bound the firm to provide advice and assistance “in all aspects” of the issuance of the refunding bonds, and that agreement imposed fiduciary obligations on the firm as a whole to disclose the markup on the government securities sold by the government securities desk. The Rauscher Motion to Dismiss stated the ordinary principal relation of a government securities desk with its customers and argued that any inference from the financial advisor contract was overcome by (1) the confirmation stating it was a principal and (2) the Certificate delivered at the closing pursuant to the arbitrage regulations stating it was a “dealer” acting in an “arm’s-length” transaction as principal for its own account in the sale of government securities.

The district court in denying Rauscher’s motion to dismiss implied that the overlap in time may have required the Rauscher investment bankers, if they were fiduciaries, to disclose separately from the confirmation or the arbitrage certificate that the government desk would be acting as a principal in the sale of the government securities. The order further concludes as follows:

Whether these were indeed two separate and distinct transactions, and whether Defendants had a fiduciary duty during the sale of the securities are both questions of fact that cannot be resolved in a motion to dismiss. Further, even if Defendants are correct in asserting that their fiduciary relationship did not extend to the sale of the securities, the existence of a fiduciary relationship during the bond offering may have required them to disclose the markup information to the [state] when they notified the [state] that they would be providing the securities.

599. See discussion above at text at note 546.
600. Rauscher Complaint, at ¶ 25.
601. Rauscher Motion to Dismiss, at 13. See further discussion of the changing roles of investment bankers at section 8:10.5[B].
603. Id. at 995.
In addition to urging that Rauscher had fiduciary duties derived from its role as financial advisor, the Rauscher Complaint requested a holding that Rauscher was an investment adviser. Investment advisers are fiduciaries by operation of law under the Advisers Acts and it is not necessary to show facts supporting the fiduciary status. The fiduciary status must be factually proved when the subject is a financial advisor.\textsuperscript{604} If the SEC is able to enforce its role changing theories and find that underwriters, financial advisors or others have acted as investment advisers, the SEC will significantly advance its ability to show that various professionals in a transaction can become fiduciaries. The SEC has recognized that a financial advisory firm that assists in structuring and timing new issues of municipal securities should not be regarded as an investment adviser for purposes of the Advisers Act,\textsuperscript{605} that there is an exemption for advice confined to government securities, but that advance refundings may involve forward contracts or other arrangements that arguably constitute separate securities from the underlying government securities.\textsuperscript{606} The \textit{Rauscher} district court found that there were sufficient issues of fact to deny the motion to dismiss.\textsuperscript{607}

\textbf{[C] Global Resolution}

In April 2000, the SEC brought and settled enforcement actions against ten investment banking firms.\textsuperscript{608} The settlements were part of a global resolution of all then-pending yield burning claims against seventeen firms brought by the SEC, NASD Regulation, Inc., the

\begin{footnotesize}
\textsuperscript{604}. See section 12:5 and section 12:6.1[A].  \\
\textsuperscript{606}. See section 12:3.5.  \\
\textsuperscript{607}. 17 F. Supp. 2d at 1001–04.  \\
\end{footnotesize}
United States Attorney for the Southern District of New York, and the U.S. Department of Treasury. The announcement by the SEC included the following summary:

The Commission’s orders allege as follows: From 1990 through 1994, each of the ten brokerage firms charged issuers of municipal refunding bonds excessive, undisclosed markups on Treasury securities. The firms also certified that the prices they charged did not exceed the securities’ fair market value under the federal tax laws, even though they knew or should have known that they were charging prices above fair market value. The false representations by the firms about the fair market value of the securities were critical to establishing the tax-exempt status of the associated municipal refunding bonds. That tax-exempt status was the bonds’ essential investment feature. In some cases, a brokerage firm’s overcharging diverted money from the U.S. Treasury to the firm. In the remaining cases, overcharging by the brokerage firm took money away from the municipality by reducing, dollar for dollar, the savings that the municipality received from the refunding. Therefore, each of the firms violated the federal securities laws by selling securities to municipalities at inflated prices and jeopardizing the tax-exempt status of the municipalities’ refunding bonds.

Without admitting or denying the findings, each firm consented to a censure, a cease-and-desist order prohibiting future violations, and agreed to disgorge the ill-gotten gains it received from the overcharging. The Commission’s actions call for payments of $118 million, $103 of which goes to the federal government and $15 million of which goes to 112 municipalities. 609