No. 04-55665

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

T. JEFFREY SIMPSON, on behalf of himself and all others similarly situated,

Plaintiff,

and,

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM,

Plaintiff - Appellant,

v.

HOMESTORE.COM, INC.; et al.,

Defendants - Appellees.

On Appeal from the United States District Court
for the Central District of California

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, IN SUPPORT OF POSITIONS THAT FAVOR APPELLANT

GIOVANNI P. PREZIOSO
General Counsel
JACOB H. STILLMAN
Solicitor
KATHARINE B. GRESHAM
Assistant General Counsel
MICHAEL L. POST
Senior Counsel

Of Counsel
MEYER EISENBERG
Deputy General Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
(202) 942-0921 (Post)

TABLE OF CONTENTS

TABLE OF CONTENTS (cont'd): PAGE

TABLE OF AUTHORITIES

CASES (cont'd): PAGE

STATUTES AND RULES: PAGE

Securities Act of 1933, 15 U.S.C. 77a, et seq.:

Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq.:

Rule under the Securities Exchange Act of 1934, 17 C.F.R. 240.01, et seq.:

MISCELLANEOUS: PAGE

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, submits this brief, amicus curiae, to address an important question concerning liability in private lawsuits, and possibly certain Commission actions, brought under the antifraud provisions of the federal securities laws:

> What is the appropriate test for finding a defendant to be a primary violator rather than an aider and abettor in a scheme to defraud under Rule 10b-5(a)?

The question arises because the Supreme Court, in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), held that private actions under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, can only be brought against persons who are primary violators and not against those who aid and abet a primary violator.

This case involves allegations that a corporation and several of its business partners engaged in a scheme to defraud investors by entering into transactions that were deceptive because their purpose and effect was to falsely inflate the corporation's revenues. These allegations raise the question whether the business partners' alleged conduct – engaging in such transactions – can make them primary violators. This situation has arisen in several recent cases involving schemes to inflate the revenues of internet companies, as well as other types of schemes to misrepresent the financial condition of publicly traded companies.

Meritorious private actions under the federal securities laws serve an important role, both because they provide compensation for investors who have been harmed by violations of the securities laws and because, as the Supreme Court has repeatedly recognized, they "provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)). See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975). Congress, in adopting the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, reaffirmed that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses" and that private lawsuits "promote public and global confidence in our capital markets and help to deter wrongdoing and guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995).

The Commission has a further interest in this case, beyond its implications for private actions. Because Central Bank was a private action under the Exchange Act, the Supreme Court did not explicitly address either the Commission's authority to bring actions against aiders and abettors or the availability of aiding and abetting liability under the Securities Act of 1933, 15 U.S.C. 77a et seq. After Central Bank, Congress, in the Litigation Reform Act, reaffirmed the Commission's authority to bring aiding and abetting actions under the Exchange Act. See Exchange Act Section 20(e), 15 U.S.C. 78t(e). The

Litigation Reform Act, however, does not give the Commission authority to proceed against aiders and abettors of violations of the Securities Act. Thus, assuming the Central Bank holding applies to the Commission, this Court's resolution of the present case could have a bearing upon the Commission's authority to proceed against violators of the antifraud provisions of the Securities Act.

STATEMENT OF THE CASE

A. Facts

Homestore.com, Inc. was a leading internet provider of real estate listings and home purchasing and moving services whose stock plummeted when the company was forced to restate its revenues for 2000 and 2001 by approximately $190 million. The restatement was necessary because Homestore had inflated its revenues through a series of transactions whose purpose and effect was to create the false appearance of legitimate revenues, thus enabling Homestore to meet or exceed targets set by Wall Street analysts and maintain the high price of the company's stock. The defendants include three companies – AOL Time Warner Inc., Cendant Corporation, and L90, Inc. – that were Homestore's business partners in the transactions; two executives at AOL; and one at Cendant, collectively referred to by the district court as the business partner defendants.

B. District Court Decision

The district court dismissed the complaint against the business partner defendants for three reasons: (1) there was no precedent for holding an outside business partner to a corporation liable to that corporation's shareholders for

securities fraud; (2) the primary architects of the scheme were the officers of Homestore, not the other companies that entered into the transactions with Homestore; and (3) Homestore's shareholders were injured by their reliance on material misstatements and omissions made by Homestore about the revenues, not the transactions that created the revenues. See In re Homestore.com, Inc. Sec. Litig., 252 F. Supp.2d 1018, 1037-42 (C.D. Cal. 2003).

The district court, citing this Court's decision in Cooper v. Pickett, 137 F.3d 616 (1998), acknowledged that a defendant may be held primarily liable for participating in a scheme to defraud after Central Bank. See id. at 1038. The court stated, however, that it was "unaware of any case since Central Bank that has ever held that outside business partners, no matter how involved they were in fraudulent transactions with a corporation, can be held liable in a private action brought by the shareholders of that company." Id. "[I]n every post-Central Bank case cited to the Court where an 'outsider' has been held liable as a primary violator, that outsider had some type of special relationship with the corporation, *i.e.* accountant, auditor, etc." Id. at 1039. The court noted that "these are exactly the types of 'secondary actors' the Supreme Court envisioned as potential 'primary violators' in Central Bank." Id. 1/ The court reasoned that holding "a business

---

1/ The Supreme Court stated in Central Bank:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all

(continued...)

partner with no special relationship to the corporation" liable would "broaden the scope of the securities acts so as to haul into court anyone doing business with a publicly traded company." Id. Thus, the court held that the plaintiffs' claims against the business partner defendants were precluded as a matter of law, and that the court therefore did not need to address the sufficiency of the complaint as to them. Id. at 1042; id. at 1038 ("Central Bank precludes liability for ordinary business partners and third party corporations doing business with the primary violator as a matter of law."). As to scheme liability in particular, the court stated that "[t]here is no indication that liability for participation in a scheme can extend beyond the corporate officers and those with a special relationship with the corporation." Id. at 1040.

With respect to a test for liability of participants in a scheme to defraud, the district court stated that although Cooper did not define the kind of scheme in which a group of defendants could be liable, "Central Bank requires a plaintiff to allege that each and every defendant committed its own independent primary violation." 252 F. Supp.2d at 1040. In order to implement this "independent primary violation" requirement, the court held that "[t]hose who actually 'employ' the scheme to defraud investors are primary violators, while those who merely participate in or facilitate the scheme are secondary violators." Id. In this case, the court found that the officers of Homestore, who were the "primary architects of

---

1/(...continued)

> of the requirements for primary liability under Rule 10b-5 are met.

511 U.S. at 191.

the scheme" and "designed and carried [it] out," had employed the scheme. Id. The court found that "other actors, such as AOL and its employees who actively participated in the *** scheme, did not 'employ' the scheme to defraud investors, and are therefore secondary violators." Id.

Finally, with respect to the reliance element in private actions, the district court found that the plaintiff "suffered damage through its reliance on false or misleading statements" about Homestore's revenues, not on the "scheme itself." Id. at 1041. Thus, the court viewed the scheme to generate false revenues as "one step removed from the injured party." Id. Because the false statements were "the principal 'wrong' alleged," the court reasoned, "it is appropriate to require defendants in this case to be connected in some material way to the drafting of the statements made to the investing public." Id. This means that the plaintiffs could not state a claim against the business partner defendants, who the district court held were not involved in the making of the false statements concerning Homestore's revenues, no matter how involved they were in the scheme to create those revenues. Id.

ARGUMENT

I. THE DISTRICT COURT'S HOLDINGS, BASED ON UNWARRANTED DISTINCTIONS, WOULD UNDERMINE THE PURPOSE OF THE ANTIFRAUD PROVISIONS.

Not only are the district court's holdings inconsistent with the language of Section 10(b) and Rule 10b-5 and the relevant case law (as explained below), but it bears emphasizing at the outset that the district court's holdings would undermine the statutory intent to protect investors against fraud and to ensure

honest markets. These holdings, and the positions taken by the business partner defendants below, would permit wrongdoers to evade liability on the basis of meaningless distinctions.

First, to require a special relationship with the corporation of which the plaintiffs are shareholders would allow a person who is not in such a relationship to accomplish the same fraud, with the same state of mind, and the same effect on investors as a person in such a relationship, and nonetheless escape liability. Wrongdoers could deliberately avoid having any such relationship arise, and effectively immunize their fraudulent conduct. Liability under Section 10(b) should be imposed on any person whose conduct comes within the proscriptions of the statute, regardless of the person's relationship with the subject corporation.

Second, to require a defendant to have designed the fraudulent scheme would have a similarly unwarranted impact. Where a wrongdoer, intending to deceive investors, engages in a deceptive act as part of a scheme to defraud, he can cause the same injury to investors, and the same deleterious effects on the markets, regardless of whether he designed the scheme. Wrongdoers could studiously avoid engaging in any design activity, and effectively immunize their conduct. An unlimited number of persons could join in a scheme where one schemer does all of the designing, and only that single schemer would be potentially liable. The district court's test would also suggest that an unlimited number of schemers could simply mimic some prior, well-publicized scheme and escape liability – none having designed it. Liability should be available against any person who engages

in a deceptive act within the meaning of Section 10(b) as part of a scheme to defraud, regardless of who designed the scheme.

Third, deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words. For example, if an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding company debt, it has achieved the same deception, and liability should be equally available.

Finally, the district court's holding with respect to the reliance element in private actions would invite similar gamesmanship. The deception created by fraudulent activity frequently will be disseminated into the marketplace through some person's making a false statement. If prior fraudulent activity, from which the making of that false statement flowed as a natural consequence, is not covered, large swaths of fraudulent activity could go unremedied. Groups of many schemers could deliberately arrange for one schemer to make the false statement on which the completion of their scheme depends. Under the district court's rule, all of the other schemers could be insulated from liability as a matter of law. The reliance element should be viewed as satisfied whenever a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction.

II. THE DISTRICT COURT MADE SEVERAL LEGAL ERRORS IN ITS RESOLUTION OF THE CLAIMS AGAINST THE BUSINESS PARTNER DEFENDANTS.

A. A defendant is not required to have a special relationship with the corporation of which the plaintiffs are shareholders to be primarily liable to them for securities fraud.

The district court ruled that a business partner with no special relationship to a company whose security is the subject of a securities fraud action cannot be liable as a primary violator. A proper analysis, however, should not focus upon whether there is such a relationship, but rather upon the conduct of the party alleged to have played a part in a fraudulent scheme.

Nothing in the language of Section 10(b) or Rule 10b-5 suggests a requirement of any special relationship among alleged co-schemers. Section 10(b) makes it unlawful for "any person" to use or employ any manipulative or deceptive device. Rule 10b-5, likewise, makes it unlawful for "any person" to engage in fraudulent conduct. The Supreme Court has observed that the "repeated use of the word 'any'" in the statute and rule is "obviously meant to be inclusive." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). The Court has expressly recognized that while "[s]ome of the express causes of action [in the securities Acts] specify categories of defendants who may be liable; others (like § 10(b)) state only that 'any person' who commits one of the prohibited acts may be held liable." Central Bank, 511 U.S. at 179. 2/

2/ See Herman & MacLean v. Huddleston, 459 U.S. 375, 382, 387 n.22 (1983); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971) (finding the "fact that the fraud was perpetrated by an officer of [the victim corporation] and his outside collaborators" to be "irrelevant" "[f]or § 10(b) bans the use of any deceptive device *** by 'any person.'"). See also United States v. Charnay, 537

(continued...)

Moreover, the district court's holding automatically excluding all business partners from primary liability is inconsistent with the Supreme Court's directive that Section 10(b) be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes.'" United States v. Zandford, 535 U.S. 813, 819 (2002). Pronouncements like the district court's may appear to have the virtue of "bright-line" certainty and predictability, but may also have the unfortunate consequence of encouraging fraudulent schemes deliberately designed to evade liability through compliance with such mechanical distinctions.

The district court supported its conclusion by misreading a passage in Central Bank in which the Court stressed that "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission)" may be primarily liable under Rule 10b-5. The district court focused on the Supreme Court's reference to lawyers, accountants, and banks, and gleaned a "special relationship" requirement. See 252 F. Supp.2d at 1039. But the words "[a]ny person or entity," and the introduction of the reference to those professional categories by the word "including," show that the categories were given by way of illustration, not limitation. This Court stated in Cooper v. Pickett that a group of defendants can be liable for acting together to violate the securities laws, "as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme." 137 F.3d at 624.

2/(...continued)
F.2d 341, 349 (9th Cir. 1976) ("[T]he language of the Rule provides no basis for concluding that only 'insiders' are subject to its requirements.").

That language did not in any way suggest a requirement that there be a special relationship among alleged co-schemers.

Indeed, the district court's standard further conflicts with Cooper v. Pickett by precluding liability even for a defendant who meets the requirement of committing a manipulative or deceptive act in furtherance of a scheme to defraud. This conflict is apparent in the district court's statement that outside business partners cannot be held liable in a private action for securities fraud "no matter how involved they were in fraudulent transactions with a corporation." In re Homestore, 252 F. Supp.2d at 1038.

B. Designing the fraudulent scheme is not required for a defendant to be primarily liable for employing a scheme to defraud.

The district court held that the primary violators in a scheme to defraud are the "primary architects" of the scheme who "designed and carried [it] out." The "use or employ" language of Section 10(b), however, suggests no such requirement. The Second Circuit, in holding a defendant primarily liable for securities fraud, found it "of no relevance" that another individual "masterminded" the stock manipulation scheme at issue. SEC v. U.S. Environmental, 155 F.3d 107, 112 (2d Cir. 1998). The district court's requirement would lead to absurd results. As noted, a group of defendants could join in a scheme with a mastermind who designed it and then the group could implement the scheme without any further involvement of the mastermind. Under the district court's test, no member of the group that implemented the scheme would be primarily liable because they had no part in designing it.

C. The district court erroneously analyzed the element of reliance.

The district court concluded that the plaintiffs could not show reliance on the business partners' conduct because they relied on Homestore's misrepresentations about its revenue, not on the scheme to create the revenue. The court appears to have assumed that the scheme to defraud did not include the actual making of the false statements about Homestore. The court viewed the transactions to generate false revenues as the scheme in which the business partner defendants were involved (for which liability did not attach because there was no reliance), and the making of false statements as a separate wrong in which the business partner defendants were not involved (for which liability could attach because there was reliance). The type of scheme in which the business partners were allegedly involved – to artificially inflate the price at which a security is traded by disseminating false information into the marketplace – does not end before the false statements are made. Indeed, at one point in its opinion, the court recognized that "the scheme was not complete until the statement was made," 252 F. Supp.2d at 1041, but then failed to take this fact into account in its analysis.

III. THE APPROPRIATE TEST FOR PRIMARY LIABILITY FOR A SCHEME TO DEFRAUD

A. Scope of the statute and rule

A principal purpose of Congress in enacting the Securities Exchange Act of 1934 was to "insure honest securities markets and thereby promote investor confidence." United States v. O'Hagan, 521 U.S. 642, 658 (1997). Section 10(b) of the Act explicitly delegated authority to the Commission to prescribe rules, "as necessary or appropriate in the public interest or for the protection of investors,"

making it "unlawful for any person, directly or indirectly," to "use or employ, in connection with the purchase or sale of any security *** any manipulative or deceptive device or contrivance." Section 10(b) (emphasis added). In 1942, consistently with the Act's broad remedial purposes, the Commission implemented Section 10(b) through the promulgation of Rule 10b-5. See Zandford, 535 U.S. at 819-20 (holding that Commission's interpretation of Section 10(b) is entitled to deference if reasonable).

Rule 10b-5 tracks the language of Section 10(b) in many respects, see Central Bank, 511 U.S. at 172 ("Rule 10b-5 *** casts the proscription in similar terms"), and closely tracks Congress's own language in Section 17(a), the general antifraud provision of the Securities Act of 1933. As pertinent here, Rule 10b-5(a) makes it unlawful for "any person," "directly or indirectly," to "employ any device, scheme, or artifice to defraud." The Supreme Court has stated that "any manipulative or deceptive device or contrivance" in Section 10(b) includes a "scheme," Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976), and that Section 10(b) applies to "complex securities frauds" in which "there are likely to be multiple violators" Central Bank, 511 U.S. at 191. Rule 10b-5(c) makes it unlawful for "any person," "directly or indirectly," to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person ***."

It has long been accepted that Section 10(b), and Rule 10b-5(a) and (c) thereunder, cover conduct beyond the making of false statements and misleading omissions, which are covered by Rule 10b-5(b). The Supreme Court has stated

that Section 10(b) encompasses deceptive "practices," Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475-76 (1977), deceptive "conduct," id. at 475 n.15; O'Hagan, 521 U.S. 659, and deceptive "acts," Central Bank, 511 U.S. at 173; see Bankers Life, 404 U.S. at 9. In the recent Zandford decision, where the Court considered a fraudulent scheme under Rule 10b-5(a) and a course of business that operated as a fraud under Rule 10b-5(c), the Court concluded: "Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' that conduct, 'without more,' was a fraud." Zandford, 535 U.S. at 815 (emphasis added); see Affiliated Ute, 406 U.S. at 152 (noting that while Rule 10b-5(b) targets false statements or omissions, paragraphs (a) and (c) "are not so restricted"); Charnay, 537 F.2d at 350 (clauses (a) and (c) prohibit deceptive "practices"). As a whole, Rule 10b-5 implements all of the authority granted to the Commission in Section 10(b). See Zandford, 535 U.S. at 816 n.1 ("The scope of Rule 10b-5 is coextensive with the coverage of § 10(b) ***."). Thus, if conduct is covered by Section 10(b), it is necessarily covered by Rule 10b-5.

The Supreme Court has stated repeatedly that Section 10(b) should be construed "'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" Zandford, 535 U.S. at 819 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)). See also Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices."); Affiliated Ute, 406 U.S. at 151 (stating Section 10(b) and Rule 10b-5 "are broad and, by repeated use

of the word 'any,' are obviously meant to be inclusive"). The Supreme Court has explained:

> [We do not think] it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that § 10 (b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.

Bankers Life, 404 U.S. at 11 n.7 (citation omitted); see Hochfelder, 425 U.S. at 203 (Section 10(b) is "a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.'").

Consideration of contemporaneous dictionary definitions of the plain language of Section 10(b) confirms its breadth. "Employ" is essentially a synonym for the verb "use," derived from the Latin word for "engage." Webster's New International Dictionary 839 (2d ed. 1934). "Use" means "to engage in," or "to put into operation." Id. at 2806; see Funk & Wagnalls, New Standard Dictionary of the English Language 2622 (1937) (defining "use" as "[t]he act of using; employment, as of means or material for a purpose"). "Scheme" means "a plan or program of something to be done." Webster's New International Dictionary 2234. "Directly" means "without anything intervening; personally." Webster's New International Dictionary 738. The definitions for "indirectly" include "not directly," and "in [a] roundabout or subtle manner." Id. at 1267.

B. The appropriate test for conduct

1. Any person can be primarily liable under Section 10(b) and Rule 10b-5(a) for engaging in a scheme to defraud, so long as he himself, directly or indirectly, engages in a manipulative or deceptive act as part of the scheme.

The Commission urges the following test for determining when a person's conduct as part of a scheme to defraud constitutes a primary violation:

> Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

This test is consistent with this Court's observation in Cooper v. Pickett that "Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme." 137 F.3d at 624. 3/

3/ Instead of the verb "commit" used in Cooper, the Commission's test uses the verb "engage" because it is more naturally applicable to acts carried out in concert by multiple actors. Using the verb "engage" is consistent with the words of Section 10(b), the statutory structure, see Securities Act Section 17(a)(3), 15 U.S.C. 77q(a)(3), the Commission's Rule adopted in 1942, 17 C.F.R. 240.10b-5(c), and the definitions given above: to "use or employ" a manipulative or deceptive device means to put the device into operation, and to engage in a manipulative or deceptive act has the same meaning. The test uses "as part of a scheme" instead of "in furtherance of a scheme," which connotes assistance and thus suggests aiding and abetting.

We do not believe that a test requiring that a defendant have "substantial participation" in a scheme would be appropriate in the context of a scheme to defraud under Rule 10b-5(a). This Court uses such a test for primary liability in false statement cases. Howard v. Everex Systems, Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) (primary liability found when secondary party had "substantial participation or intricate involvement" in preparation of fraudulent statements).

(continued...)

It is essential that the test for primary liability provide a meaningful distinction between a primary violator and an aider and abettor; otherwise, there is a risk that primary liability would be extended to cover activity that should properly be viewed as only aiding and abetting. The Commission's test, which requires that a particular defendant engage in a manipulative or deceptive act as part of the scheme, provides such a meaningful distinction, and is consistent with Section 10(b) and Central Bank. The Central Bank Court defined an aider and abettor as one whose conduct does not come within the proscriptions of Section 10(b), but who assists another whose conduct is covered by Section 10(b). See 511 U.S. at 184. The Court found aiding and abetting liability, so defined, to be precluded by the plain language of Section 10(b). See id. at 177. The Court stated: "We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." Id. The test the Commission urges, by requiring that each defendant engage in a manipulative or deceptive act for primary liability to attach, ensures – by language taken from Section 10(b) itself – that only conduct covered by Section 10(b) is

---

3/(...continued)
That test, however, derives from the Rule 10b-5(b) context, which presents the special problem of interpreting the verb "make" in paragraph (b) of the Rule. This Court requires "significant participation" in the scenario where the defendant was not publicly identified with a false statement, and thus can only be considered as having "made" the statement if the defendant substantially participated in its drafting or editing. Rule 10b-5(a), however, uses the verb "employ," which, as noted above, does not suggest a requirement that a person be involved in designing, planning, or otherwise creating a scheme.

sufficient for primary liability. 4/ Several district courts construing Section 10(b) and Rule 10b-5(a) are in accord with this approach and Cooper. 5/

2. Engaging in a transaction whose principal purpose and effect is to create a false appearance of corporate revenues constitutes a deceptive act that can support primary liability.

It is reasonable to construe Section 10(b) as encompassing, within the rubric of engaging in a deceptive act, engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues. This rule follows from the well-established principle that facts can be misrepresented by conduct as well as

---

4/ This Court made reference in Cooper v. Pickett to "direct[] participat[ion]" in a scheme. 137 F.3d at 624. We do not believe that direct conduct should be a requirement for primary scheme liability. Section 10(b) and Rule 10b-5 expressly cover "indirect" conduct. Thus, a defendant should be primarily liable where he either directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud. See In re Lernout & Hauspie Sec. Litig., 236 F. Supp.2d 161, 173 (D. Mass. 2003) (holding that any person can be primarily liable who participates in a scheme to defraud "by directly or indirectly employing a manipulative or deceptive device").

5/ See, e.g., In re Enron, 310 F. Supp.2d 819, 827-30 (S.D. Tex. 2004) ("reject[ing] the narrow construction of the statute [in] Homestore.com"); In re Lernout & Hauspie Sec. Litig., 236 F. Supp.2d at 173 (holding that any person can be primarily liable "who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors ****"); In re Enron, 235 F. Supp.2d 549, 592 (S.D. Texas 2002) ("If a plaintiff meets the requirements of pleading primary liability as to each defendant, i.e., alleges with factual specificity (1) that each defendant made a material misstatement (or omission) or committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud, (2) scienter, and (3) reliance, that plaintiff can plead a scheme to defraud and still satisfy Central Bank.") (emphasis added); In re ZZZZ Best Sec. Litig., 864 F. Supp. 960, 969 (C.D. Cal. 1994) (Central Bank "makes clear that more than simply knowing assistance with the underlying fraudulent scheme is required;" "Plaintiffs must prove that [defendants] engaged in some form of deception that is prohibited by Rule 10b-5.").

words. 6/ If two companies together make a false statement about the revenues of one of them, both companies could be primarily liable for securities fraud. If they together achieve the same deception through conduct rather than words, the same result should obtain. See supra pp. 13-14 (explaining that Section 10(b) and Rule 10b-5 cover conduct beyond the making of false statements and misleading omissions).

This rule is also consistent with Section 10(b)'s coverage of market manipulation, which typically involves conduct that creates a false appearance of trading activity. See United States v. Russo, 74 F.3d 1383, 1391 (2d Cir. 1996) (holding trading scheme which "create[d] a false impression" of demand for the subject stock constituted market manipulation under Section 10(b) and Rule 10b-5). 7/

* * * * *

6/ A legal dictionary in use at the time of Section 10(b)'s enactment defined "deception" as follows: "The act of deceiving; intentional misleading by falsehood spoken or acted." See Black's Law Dictionary 529 (3d ed. 1933) (emphasis added). See also The Random House Unabridged Dictionary of the English Language 516 (2d ed. 1987) ("deceive *** 1. to mislead by a false appearance or statement") (emphasis added); 37 Am. Jur.2d Fraud and Deceit § 38 (2004) ("[F]raud may consist of *** the creation of a false impression by words or acts ***."). "I can see no substantial distinction between false rumours and false and fictitious acts." Scott v. Brown, Doering, McNab & Co., [1892] 2 Q.B. 724, 730 (C.A.) (recognizing that manipulation can occur without the dissemination of false statements) (quoted approvingly in Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 7 n.4 (1985)).

7/ See also GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 204 (3d Cir. 2001) (holding trading activity that "created a false impression of market activity" can violate Section 10(b)); SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, (2d Cir. 1978) (Friendly, J.) (finding violation in case of "large-scale manipulation" where defendant created phony nominee accounts to "create a false appearance" that a large number of securities had been sold); cf. Section 9 of the Exchange Act, 15 U.S.C. 78i.

Consideration of hypothetical scenarios confirms that the above approach would appropriately distinguish between conduct to which primary liability should attach and mere aiding and abetting. For example, a bank that makes a loan, even knowing that the borrower will use the proceeds to commit securities fraud, is at most an aider and abettor. The bank itself has not engaged in any manipulative or deceptive act because there is nothing manipulative or deceptive about the bank's making of the loan. Likewise, if an investment bank provides services to arrange financing for a client, knowing the client will use the proceeds to commit securities fraud, then it is at most an aider and abettor. If, however, the investment bank engages in the creation of a sham entity as part of the services to arrange the financing, the investment bank may be a primary violator if it acted with scienter. The investment bank itself engaged in a deceptive act.

In the context of the overstatement of revenues, if a third party enters into a legitimate transaction with a corporation, knowing that the corporation will overstate the revenue generated by the transaction, the third party is at most an aider and abettor. There is nothing deceptive about the third party entering into the legitimate transaction. If, however, the third party engages with the corporation in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation's stock, it may be a primary violator.

Similarly, if a third party enters into a sale-of-goods transaction with a corporation where the terms include a legitimate option on the part of the third party (the buyer) to return the goods for a full refund, knowing that the corporation

will misrepresent the transaction as a final sale, the third party is at most an aider and abettor. If, however, the parties to the transaction have a side oral agreement that no goods will be delivered and no money will be paid, and the corporation falsely reflects revenue from the transaction, the third party could be a primary violator.

C. The reliance requirement is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive 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 in Central Bank stressed the importance of the reliance requirement in distinguishing primary liability from aiding and abetting liability. 8/ 511 U.S. at 180 ("Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions."). The Court, however, had no occasion in that case to address the reliance requirement in the context of a scheme to defraud under Rule 10b-5(a).

Reliance in securities fraud cases is a form of transaction causation, which is established where the plaintiff's reliance on the defendant's fraudulent conduct caused the plaintiff to engage in his securities transaction. See Harris v. Union Elec. Co., 787 F.2d 355, 366 (8th Cir. 1986); Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 n.23 (2d Cir. 1984). Nothing in the rules of causation suggests that only the final act in a scheme to defraud meets the causation requirement. Indeed, in Cooper v. Pickett, this Court held a maker of false

---

8/ Reliance is an element in private actions, but is not required in Commission actions. See SEC v. Rana Research Inc., 8 F.3d 1358, 1363-64 (9th Cir. 1993).

statements primarily liable, although the deceptive information flowed into the marketplace through the intervening conduct of subsequent speakers. 137 F.3d 624-25; see In re Lernout & Hauspie Sec. Litig., 236 F. Supp.2d at 173 (holding a person who employs a deceptive device as part of a fraudulent scheme may be primarily liable "even if a material misstatement by another person creates the nexus between the scheme and the securities market"). Cooper's holding implicitly recognized that subsequent conduct that does not break the causal chain can include another party's making of false statements. See also In re ZZZZ Best, 864 F. Supp. at 973. Although reliance on the acts of defendants who do not themselves disseminate information to the securities market may be indirect, liability in these circumstances is fully consistent with Section 10(b) and Rule 10b-5's explicit coverage of deceptions accomplished "directly or indirectly." See supra pp. 12, 13.

Thus, a prior deceptive act, from which the making of the false statements follows as a natural consequence, can constitute a sufficient step in the causal chain to support a finding of reliance. Certainly where the making of the false statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation. See Warshaw v. Xoma Corp., 137 F.3d 955, 959 (9th Cir. 1996) (If "Xoma intentionally used these third parties to disseminate false information to the investing public," it "cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties."). Another example of subsequent conduct that should not break the causal chain would be an outside

auditor's failure to detect another person's deceptive act – or even the auditor's fraudulent certification of financial statements as part of the scheme. A person should not be able to escape liability simply because his deceptive act also deceived the outside auditor – or because the outside auditor also engaged in the fraudulent scheme.

CONCLUSION

For the foregoing reasons, the Court should hold that any person who has the requisite scienter can be liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) thereunder when he, directly or indirectly, engages in a manipulative or deceptive act as part of a scheme to defraud; that engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues constitutes such a deceptive act; and that the reliance requirement in private actions is satisfied where a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction.

Respectfully submitted,

GIOVANNI P. PREZIOSO
General Counsel

JACOB H. STILLMAN
Solicitor

KATHARINE B. GRESHAM
Assistant General Counsel

MICHAEL L. POST
Senior Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0606
(202) 942-0921 (Post)

Of Counsel
MEYER EISENBERG
Deputy General Counsel

October 2004

A D D E N D U M

TABLE OF CONTENTS

FRAUDULENT INTERSTATE TRANSACTIONS

Section 17. [77q] (a) Use of interstate commerce for purpose of fraud or deceit--It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly–

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. * * * *

MANIPULATIVE AND DECEPTIVE DEVICES

Section 10. [78j] 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-- * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. * * * *

EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES

17 C.F.R. 240.10b-5

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.

CERTIFICATE OF SERVICE

I hereby certify that, on this day, I caused an original and four copies of the Motion of the Securities and Exchange Commission for Leave to File Amicus Curiae Brief Out of Time, and the original and fifteen copies of the foregoing brief to be sent by overnight delivery to

Cathy Catterson
Clerk of Court
U.S. Court of Appeals for the Ninth Circuit
95 Seventh Street
San Francisco, CA 94103-1526

and a copy of the Commission's motion and two copies of the foregoing brief to be sent by overnight delivery to

John B. Quinn, Esq.
Quinn Emanuel Urquhart
Oliver & Hedges
865 South Figueroa Street
Los Angeles, CA 90017

Samuel Kadet, Esq.
Skadden, Arps, Slate, Meagher
& Flom
Four Times Square
New York, NY 10036

F. Whitten Peters, Esq.
Williams & Connolly
725 - 12th Street, NW
Washington, DC 20005

Edward S. Nathan, Esq.
Stern Greenberg & Kilcullen
75 Livingston Avenue
Roseland, NJ 07068

Michael C. Tu, Esq.
Orrick Herrington & Sutcliffe
777 S. Figueroa Street
Los Angeles, CA 90017

Belinda Lee
Lathan & Watkins
633 W. Fifth Street, Suite 4000
Los Angeles, CA 90071-2007

Roger C. Spaeder, Esq.
Zuckerman Spaeder Goldstein
Taylor & Kolker
1201 Connecticut Ave., NW
Suite 1200
Washington, D.C. 20036

Paul D. Murphy, Esq.
Murphy Rosen & Cohen
100 Wilshire Boulevard
Suite 700
Santa Monica, CA 90401

Everett C. (Kip) Johnson, Jr., Esq.
Latham & Watkins
555 Eleventh Street, N.W.
Suite 1000
Washington, DC 200004-1304

Eric A. Isaacson
Lerach Coughlin Stoia Geller
Rudman & Robbins
401 'B' Street
San Diego, CA 92101

Nancy L. Fineman, Esq,
Cotchett Pitre Simon &
McCarthy
840 Malcolm Road
San Francisco, CA 94010

Michael L. Post
Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0606
(202) 942-0921

October 21, 2004

CERTIFICATE OF COMPLIANCE
Pursuant to Fed. R. App. P. 32(a)(7)(C) and Circuit Rule 32-1
For Case Number 04-55665

I hereby certify that pursuant to Fed. R. App. P. 32(a)(7)(C) and Ninth Circuit Rule 32-1, the attached answering brief is proportionately spaced, has a typeface of 14 points or more, and contains 6,655 words.

_____

Michael L. Post
Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0606
(202) 942-0921

October 21, 2004