# 08-0201-CV

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant

v.

OLEKSANDR DOROZHKO,

Defendant-Appellee.

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On Appeal from the United States District Court
for the Southern District of New York

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**REPLY BRIEF OF THE**
**SECURITIES AND EXCHANGE COMMISSION,**
**APPELLANT**

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## INTRODUCTION

The sole argument offered by defendant Oleksandr Dorozhko in support of the district court's denial of a preliminary injunction and dissolution of the asset freeze is that *every* violation of the Section 10(b), the general antifraud provision of the Securities Exchange Act of 1934, requires proof of a breach of fiduciary duty. This argument is contrary to the plain language of the statute, the legislative history, relevant Supreme Court precedent, and the decisions of this Court and at least four other Courts of Appeals.

## ARGUMENT

Congress enacted the federal securities laws after the stock market crash of 1929, and after half of the new securities sold during the post-World War I period turned out to be worthless. *See generally,* Joel Seligman, *The Transformation of Wall Street*, at 1-2 (Rev. ed. 1995). One main feature of the laws was broad anti-fraud protection designed to ensure market integrity, protect investors, and foster the investor confidence that is essential to capital formation. In the Securities Exchange Act of 1934, the general anti-fraud provision is Section 10(b), which outlaws, in connection with the

purchase or sale of securities, "any deceptive device or contrivance" in contravention of Commission regulations. Rule 10b-5, adopted by the Commission, prohibits, among other things, "any device, scheme, or artifice to defraud," and "any act, practice, or course of business which operates . . . as a fraud or deceit upon any person."

These provisions reach all sorts of fraudulent schemes. The Supreme Court has explained that Section 10(b) and Rule 10b-5 "prohibit all fraudulent schemes in connection with the purchase or sale of securities," *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971), while the principal drafter famously paraphrased the statute as "Thou shalt not devise any other cunning devices." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976), quoting Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934) (Thomas Corcoran).

Now, nearly 75 years after passage of the Exchange Act, defendant offers a startling new reading of the law: what Congress actually meant is "Thou shalt not breach any fiduciary duty; absent such a duty, thou mayest lie as much as thou wishes." In Dorozhko's view, Section 10(b) was

enacted to impose federal disclosure duties solely on fiduciaries, people who were already subject to heightened disclosure and other obligations, and was not concerned at all with run-of-the-mill fraudsters who would deceive a stranger in a securities transaction.

As many circuits have held, this reading is insupportable, yet it is the only ground on which Dorozhko now defends the district court's denial of a preliminary injunction and dissolution of the asset freeze in this case. The district court's decision should be reversed.

## I. Because the Commission urges that the district court made an error of law, the issue on appeal is reviewed *de novo*, not with deference to the district court.

Dorozhko incorrectly proposes that because review of the denial of a preliminary injunction is for abuse of discretion, this Court owes deference to the district court's legal conclusions, and that the Commission must make a "strong showing" that the district court made an error of law. Br. 8-9.[1] To the contrary, because the Commission does not challenge the district court's exercise of judgment, but rather its *legal* conclusion (that

[1] "Br. __" is Dorozhko's brief in this Court. "SEC Br. __" is the Commission's opening brief.

breach of fiduciary duty is a necessary element of every claim brought under Section 10(b), even those involving affirmative misstatements, deceptive conduct, or half truths), this Court reviews the district court's "determination of law *de novo*. If the District Court has based its decision on an error of law, it has *ipso facto* abused its discretion." *New York Magazine v. Metro. Transp. Auth.*, 136 F.3d 123, 126 (2d Cir. 1998) (citations omitted); *see also*, *County of Nassau, N.Y. v. Leavitt*, 524 F.3d 408, 414 (2d Cir. 2008).

## II. For purposes of this appeal, defendant expressly disavows reliance on the argument that hacking is not deceptive, and urges as a basis for affirmance only that lies, deceptive conduct, and half-truths do not violate Section 10(b) absent a breach of fiduciary duty.

The Commission's opening brief demonstrated that hacking is a deceptive device or contrivance under Section 10(b). SEC Br. 18-40. Dorozhko, however, renounces reliance on the argument that his conduct was not deceptive as a ground for affirming the district court in this appeal. Br. 36-37. Instead, his sole defense of the district court's decision in this Court is the argument that "violations of Section 10(b) must be predicated on a breach of fiduciary (or similar) duty." Br. 10-11; *see also*, Br. 18 (the

Supreme Court "equates a violation of Section 10(b) with breach of a fiduciary or similar duty").[2]

The district court held an evidentiary hearing with testimony by various witnesses and reviewed extensive briefing by both parties regarding whether hacking is deceptive, and we have fully briefed the issue here. We believe that it would be appropriate for this Court to decide this issue, in addition to the breach of fiduciary duty issue, and if it agrees with us on both, it should direct the district court to grant a preliminary injunction and continue the asset freeze. *See Chertkova v. Connecticut. Gen. Life Ins. Co.*, 92 F.3d 81, 88 (2d Cir. 1996) (exercising discretion to review an issue the district court did not decide). Alternatively, based upon our argument

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[2] We note that this Court's recent decision in *United States v. Finnerty* provides additional support for the Commission's argument that hacking is a "deceptive device or contrivance" within the meaning of Section 10(b). This Court reiterated the Supreme Court's statements that "[c]onduct itself can be deceptive," so that liability under Section 10(b) and Rule 10b-5 does not require "a specific oral or written statement." *Finnerty*, No. 07-1104, 2008 WL 2778830, at *4 (2d Cir. July 18, 2008), *quoting Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S. Ct. 761, 769 (2008). And it explained that "deception" is a "broad" concept that "irreducibly entails some act that gives the victim a false impression." *Id.* This understanding of the meaning of deception is the basis for the Commission's argument, *see* SEC Br. 21-22.

concerning breach of fiduciary duty, this Court should reverse the district court's denial of a preliminary injunction, remand for the district court to consider the deception issue in the first instance, and keep the asset freeze in effect pending the district court's consideration of that issue.

## III. Lies, deceptive conduct and half-truths are deceptive devices or contrivances whether they involve a breach of fiduciary duty or not.

A false statement, deceptive action, or half-truth is a paradigmatic example of deception under both the common law and the federal securities laws. It has been clear at least since the Supreme Court's insider trading cases that silence can also be deceptive under the securities laws, as under the common law, when a fiduciary or a similar duty of trust and confidence imposes a duty to speak. Dorozhko purports to find that the special case of the fiduciary who does not speak is in fact the entire law of securities fraud. His contentions are erroneous.

### A. The language and legislative history of Section 10(b) establish that it is designed to reach all sorts of fraud.

Statutory language and legislative history are the usual tools for construing statutes, of course, but both contradict Dorozhko's fiduciary

duty theory. As we have seen (SEC Br. 19-22, 43), the ordinary meaning of the language of the statute – "any deceptive device or contrivance" – covers all sorts of fraud, and does not remotely suggest that only fiduciaries can be violators. *See In re Edelman*, 295 F.3d 171, 177 (2d Cir. 2002) ("Where the statutory terms are clear, our inquiry is at an end"). The language of the Rule is similarly broad: "any device, scheme, or artifice to defraud," and "any act, practice, or course of business which operates as a fraud or deceit upon any person." Indeed, Dorozhko's concession (Br. 17) that breach of fiduciary duty is not required under the mail and wire fraud statutes is telling, since Section 10(b)'s language provides no more basis for such a requirement than does the mail or wire fraud language. *See* 18 U.S.C. 1341 (mail fraud), 18 U.S.C. 1343 (wire fraud).[3]

The legislative history is also inconsistent with the idea that the statute reaches only breaches of fiduciary duties. The principal drafter described the provision as a "catchall" intended to permit the Commission to "deal with new manipulative or cunning devices." *Hochfelder,* 425 U.S. at 202

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[3] The mail fraud and wire fraud statutes contain identical language prohibiting "any scheme or artifice to defraud."

(quoting Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934)) (Thomas Corcoran) (internal brackets omitted). And the Senate Report explained that the section authorized the Commission "to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interests of the investor." S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934). It is inconceivable that Congress intended Section 10(b) to be a "catchall" only for fiduciaries, or that "any deceptive practice" means "any breach of fiduciary duty."

Perhaps because the task is manifestly impossible, Dorozhko does not even try to base his argument on the statutory language or legislative history. Rather he relies principally on a misreading of case law, which he contends establishes a fiduciary duty requirement that is not based on statutory language or legislative history. We next turn to these errors of his analysis.

### B. Precedent makes clear that false statements, deceptive conduct, and half-truths violate Section 10(b) and Rule 10b-5 regardless of the existence of fiduciary duties.

The fundamental principle that fraud means *either* affirmative deceptive conduct, regardless of the existence of a fiduciary duty, *or* silence when a duty requires disclosure, is interwoven into the very fabric of decisions construing Section 10(b).

For example, in this Court's recent decision in *United States v. Finnerty*, the issue was whether a specialist on the New York Stock Exchange engaged in deception within the meaning of Section 10(b) and Rule 10b-5 when he interposed himself between customer orders that were sent to him to be executed on the floor of the exchange. *Finnerty*, No. 07-1104, 2008 WL 2778830, at *1-2. This Court noted that the government "did not try to prove that Finnerty owed a fiduciary duty to public customers." *Id.* at *3. Under Dorozhko's view, that should have been the end of the Court's analysis. But it was only a prefatory observation before the Court turned to the question of whether, in the absence of an allegation of manipulation, there was proof of "a false statement, breach of a duty to disclose, *or* deceptive communicative conduct." *Id.* at *6 (emphasis added); *see also*, *id.*

at *7 (finding that there was "no material misrepresentation, no omission, no breach of a duty to disclose, and no creation of a false appearance of fact by any means").

The Court ruled that the defendant had not made an actionable misrepresentation, but it was clear that despite the absence of a claim of breach of fiduciary duty, the government would have established "a primary violation of § 10(b)" if it had shown that false customer expectations were based "on a statement or conduct by Finnerty." *Id.* at *6. *See also*, *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999) (holding that a defendant violates Section 10(b) and Rule 10b-5 when he makes either "a material misrepresentation *or* a material omission as to which he had a duty to speak.") (emphasis added).

### 1. The Supreme Court's insider trading cases rest on the understanding that affirmative misrepresentations, which includes deceptive conduct, are deceptive regardless of the breach of a fiduciary duty.

The Commission's opening brief explained that according to the Supreme Court's insider trading cases, a breach of duty is a basis for finding fraud under Section 10(b) in the specialized situation where the

deception arises, not from an affirmative misrepresentation, but through silence where there is a duty of disclosure. SEC Br. 44-49. These cases articulate what is generally referred to as the "disclose or abstain from trading" rule: a fiduciary in possession of material, nonpublic information must either abstain from trading on it or make appropriate disclosure, and the failure to do so is a form of fraud.

The case now before the Court is different from the insider trading cases addressed by prior decisions of the Supreme Court because the fraud here is alleged to be the deceptive manner in which the information was obtained rather than in the fact that the defendant traded in breach of a duty. Nevertheless, these cases provide compelling support for the proposition that an affirmative misrepresentation (which, as we have seen, includes deceptive conduct) is fraudulent.

In the first of these decisions, *Chiarella*, the Court explained that "[a]t common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent," but one who fails to disclose material information "commits fraud only when he is under a duty to do so" because he has a "fiduciary or other similar relation of trust and

confidence . . ." *Chiarella v. United States*, 445 U.S. 222, 227-28 (1980). The Court then applied these common law principles to Section 10(b), holding that silence is not fraudulent unless a duty requires disclosure.[4]

Dorozhko, however, claims that the Court created a different rule in *Chiarella*. According to him, from the premise that at common law an affirmative misrepresentation is fraudulent, while a failure to disclose is only fraudulent if there is a duty to make disclosure, the Court drew the conclusion that not only is silence fraudulent if there is a breach of duty, but also that misrepresentations can *never* be fraudulent *unless* there is a breach of fiduciary duty. As we just saw, and as further explained in our opening brief, this conclusion is unsupported by *Chiarella* or any other decision of the Supreme Court.[5]

Dorozhko incorrectly argues that this case is "virtually indistinguishable" from *Chiarella* and *O'Hagan* because, he says, like the

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[4] Subsequent insider trading cases apply the same rule. *See Dirks v. SEC*, 463 U.S. 646, 659-60 (1983) (liability of those who are tipped confidential information); *United States v. O'Hagan*, 521 U.S. 642 (1997) (liability of those who misappropriate confidential information).

[5] As we discuss below, *infra* at 21-27, it is also inconsistent with decisions of this Court and other circuit courts.

defendants in those cases, he is alleged to have "stolen" nonpublic information, and therefore, like the defendants in those cases, he is only liable for securities fraud if he had a fiduciary duty. Br. 11-17, 23-26. This assertion is incorrect. The focus in *Chiarella* and *O'Hagan* was not on how the information was obtained, but on whether, once the information had been obtained, the defendant thereafter committed fraud by trading in breach of a fiduciary duty.[6]

The Court in *O'Hagan* was explicit on this point: the fraud in a misappropriation case is "consummated, *not when the fiduciary gains the confidential information*, but when, without disclosure to his principal, he uses the information to purchase or sell securities." 521 U.S. at 656

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[6] Dorozhko similarly argues that the deception in *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991) was in how the defendant accessed the nonpublic information. Br. 24-25. Although Cherif used an identification card to falsely represent that he was authorized to enter the bank, and the court characterized this as fraudulent, the court's decision ultimately turned on the conclusion that he continued to owe a fiduciary duty to his employer even after his employment terminated. 933 F.2d at 411. The court did not reach the question of whether fraudulent entry absent a duty violated Section 10(b). *See* SEC Br. 31 n.12, *id.* at 29-32.

(emphasis added).[7] *Chiarella* likewise identified the controlling legal issue as "whether silence may constitute a manipulative or deceptive device," not whether it is fraud to obtain information through deception. 445 U.S. at 226 (this case "concerns the legal effect of the [defendant]'s silence"). In contrast, the Commission here alleges that the means by which Dorozhko obtained the information was deceptive.[8]

Nor does the fact that some of Dorozhko's conduct might be characterized as stealing mean that a fiduciary duty must be shown. As the Commission explained in its opening brief, merely because conduct might qualify as theft does not mean that it is not also deceptive within the meaning of Section 10(b). SEC Br. 37 n.16. This Court recently touched on this point in *Finnerty* when it noted that "[t]heft *not accomplished by deception*

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[7] Contrary to Dorozhko's suggestion (Br. 24), O'Hagan's mail fraud conviction was not based on some deceptive device he used to obtain the information, but on "the mailing of securities trading confirmation slips to him by his brokers." *United States v. O'Hagan*, 139 F.3d 641, 652 (8th Cir. 1998) (*on remand*).

[8] By claiming that he merely "stole" information (Br. 14, 21), Dorozhko may intend to suggest that he did not engage in any deceptive conduct to obtain it, but for this appeal he has expressly disclaimed reliance on the argument that he did not engage in deceptive conduct as a ground for affirming the district court (Br. 36-37).

(*e.g.*, physically taking and carrying away another's property) is not fraud absent a fiduciary duty." *Finnerty*, No. 07-1104, 2008 WL 2778830, at *4 (quoting *In re Refco Capital Markets, Ltd. Brokerage Customer Sec. Litig.*, 2007 WL 2694469, at *8 (S.D.N.Y. Sept. 13, 2007) (emphasis added). Assuming that some of Dorozhko's conduct might also be characterized as theft, it was accomplished through deception, and was therefore within the proscriptions of Section 10(b) and Rule 10b-5 regardless of the absence of a breach of fiduciary duty.

Dorozhko also incorrectly suggests that the Commission is seeking to revive Justice Blackmun's dissent in *Chiarella* in an effort to prohibit any "informational advantage" that arises from "mere possession" of nonpublic information. Br. 13-15 (citing 445 U.S. at 251). The fraud here is not that Dorozhko merely *possessed* nonpublic information but that he *engaged in a deceptive device of hacking* to obtain and immediately trade on that nonpublic information.

He cites to several scholarly works that suggest that hacking does not violate Section 10(b). Br. 19-20. These scholars, however, were not suggesting that Section 10(b) can only be violated where there is a breach of

fiduciary duty, even if the defendant engages in deceptive conduct. Rather, they were speculating, with little discussion or analysis, that hacking could be deemed similar to theft-without-deception, an argument that Dorozhko is expressly not making in this appeal.

We note that Dorozhko incorrectly describes the views expressed in a leading securities law treatise. Br. 20-21 n.7. As explained in our opening brief, the author of the treatise is of the view that deceptively hacking into a computer system to obtain nonpublic information is securities fraud irrespective of a fiduciary duty. SEC. Br. 23 (citing Donald C. Langevoort, 18 *Insider Trading: Regulation, Enforcement, and Prevention*, Section 6:14 (*2007*)). His treatise was updated after the Commission's opening brief was filed, but the author still concludes that a hacker who "engages in some trickery to gain access to a company's e-mail system" has engaged in deceptive acts or practices in violation of Rule 10b-5, "fiduciary breach or not." Donald C. Langevoort, 18 *Insider Trading Regulation, Enforcement and Prevention*, Section 6:14, "Deception without breach of fiduciary duty" (April 2008). He continues to be of that view after the district court's decision in this case, and he does not say, as Dorozhko suggests (Br. 20-21

n.7), that the district court's ultimate decision was correct. Rather, he says that the district court is correct that Dorozhko is not liable under the theories adopted in the Supreme Court's insider trading cases, which, as noted, require a breach of a fiduciary duty. What Langevoort thinks was "restrictive" (Br. 21 n.7) was not the district court's application of the theories from the Supreme Court decisions, but its failure to find that a defendant can also commit fraud based on his use of deception in obtaining the information.

#### 2. Supreme Court decisions not involving trading on non-public information also demonstrate that fraud may be based *either* on a misrepresentation *or* on a failure to speak in violation of a duty.

The Commission's opening brief explained that *Stoneridge*, 128 S. Ct. 761, distinguished between a fraud involving the failure to disclose in breach of a duty and a fraud where the defendant made an affirmative misstatement. SEC Br. 47-49. After the Court found that in a private action under Section 10(b) there was no presumption of reliance because the defendant "had no duty to disclose," the case did not end there – which it would have if a breach of duty was the beginning and end of Section 10(b). Rather, after

deciding the fiduciary duty issue the Court went on to decide that there was no reliance on affirmative misstatements because the "deceptive acts were not communicated to the public." 128 S. Ct. at 769.

Dorozhko agrees that in *Stoneridge* the Court analyzed reliance "in *two* circumstances" – first, "where there is an omission of material fact by one with a duty to disclose," and second where "deceptive statements become public." Br. 29 (emphasis added). This concession contradicts Dorozhko's entire theory, because Dorozhko's premise is that Section 10(b) only involves *one* circumstance (the omission of material fact by one with a duty to disclose) and that the second circumstance (deception without breach of duty) does not violate the statute.

The Commission similarly explained that *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988) demonstrates that breach of fiduciary duty cases are distinct from affirmative misrepresentation cases because the Supreme Court refused to recognize one standard of materiality for situations where a fiduciary fails to disclose or abstain from trading, and another covering affirmative misrepresentations by those "under no duty to disclose (but under the ever-present duty not to mislead)." SEC Br. 49. There would

have been no reason for the Court to consider this issue if, as Dorozhko claims, only fiduciaries have the "ever-present duty not to mislead."

Dorozhko does not come to grips with this argument about *Basic*, and can only muster that this statement is "dicta" because it was made "in passing in a footnote" (Br. 27-28). *Basic*'s statement was not dicta; it was a basis for not adopting two separate standards for materiality. It has been relied upon in holding that misrepresentations alone are actionable under Section 10(b). *See Fry v. UAL Corp.,* 84 F.3d 936, 937-38 (7th Cir. 1996) ("The duty not to make misrepresentations does not depend on the existence of a fiduciary relationship.") (citing *Basic*, 485 U.S. at 240 n.18). In an additional statement, *Basic* reaffirmed that "Rule 10b-5 is violated whenever assertions are made . . . if such assertions are false or misleading or are so incomplete as to mislead." *Basic*, 485 U.S. at 235 n.13 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (*en banc*)).[9]

Dorozhko argues that *SEC v. Zandford*, 535 U.S. 813 (2002) supports his reading of Section 10(b) because "the Section 10(b) violation was predicated

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[9] Dorozhko also argues that *Basic* preceded *O'Hagan* (Br. 27-28), but *Basic* was decided eight years after *Chiarella*'s recognition that fraud includes both misrepresentations and silence in breach of duty.

on Zandford's breach of a fiduciary duty owed to his client." Br. 18. But the fact that *some* fraud is perpetrated by the silence of fiduciaries provides no support for the notion that fraud can *only* be perpetrated by fiduciaries. One statement by the Court makes clear that it was fully aware that fraud may be committed either through affirmative deception or through omissions to disclose in breach of a duty. In response to Zandford's argument that he should escape liability because he did not make an affirmative misrepresentation, but rather "simply failed to inform [his client] of his intent to misappropriate their securities, " the Supreme Court explained that "any distinction between omissions and misrepresentations is illusory *in the context of a broker who has a fiduciary duty* to her clients." *Id.* at 822-23 (citing *Chiarella*, 445 U.S. at 230) (emphasis added). If Dorozhko's view of the law were correct, there would never be a distinction between omissions and misrepresentations because only fiduciaries could breach the statute in the first place.

### 3. Contrary to Dorozhko's assertion, circuit court decisions, including the two examples cited in the Commission's opening brief, hold that affirmative misrepresentations can violate Section 10(b) and Rule 10b-5 regardless of the absence of a fiduciary duty.

Dorozhko asserts that the Commission "can not cite any case where Section 10(b) liability has been imposed in the absence of a breach of a fiduciary duty." Br. 21, *id.* at 31. This claim is a bold one for Dorozhko to make, as he cites no appellate case in the history of the Exchange Act in which a defendant who made a material misrepresentation escaped liability on the ground that he did not breach a fiduciary duty, and he cites no appellate decision (or commentator, for that matter) supporting the view that lies are only deceptive if the liar is a fiduciary. Perhaps almost as telling are the many, many decisions holding defendants liable for violating Section 10(b) without any discussion at all of whether the

defendant was a fiduciary.[10]

The Commission's opening brief cited two examples from this Court in which Section 10(b) and Rule 10b-5 violations were found despite the absence of a fiduciary duty (SEC Br. 49-53), and, as we show below, Dorozhko's efforts to distinguish those cases are wide of the mark. We also offer additional cases that expressly distinguish *Chiarella* and the "disclose or abstain from trading" rule, and do not require a breach of duty where the securities frauds are carried out by non-fiduciaries who make affirmative misrepresentations.[11]

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[10] *See*, *e.g.*, *Superintendent v. Bankers Life*, 404 U.S. at 9 (fraudulent acts by bond issuer); *Manufacturers Hanover Trust Co. v. Drysdale Securities Corp.*, 801 F.2d 13, 20-22 (2d Cir. 1986) (accountants' misrepresentations made to client's counterparty); *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 102 (2d Cir. 2007) (fraud by "bankers and non-issuer sellers"); *Levitt v. Bear Stearns & Co.*, 340 F.3d 94 (2d Cir. 2003) (clearing agent's misrepresentations); *SEC v. George*, 426 F.3d 786 (6th Cir. 2005) ("Ponzi" scheme); *United States v. Andrews*, 146 F.3d 933 (D.C. Cir. 1998) ("prime bank" securities scheme).

[11] As noted in the discussion of the *Finnerty* decision, misrepresentations under the securities laws include not only untrue statements but also deceptive conduct. *Supra* at 5 n.2.

**a. Our opening brief cited two examples from this Court of deceptive conduct that violates Section 10(b) without a breach of fiduciary duty – pump-and-dump schemes and manipulations.**

**Pump-and-dump schemes.** In *United States v. Skelly*, 442 F.3d 94, 97-98 (2d Cir. 2006), this Court affirmed a jury verdict that defendants violated Section 10(b) and Rule 10b-5 in perpetrating a pump-and-dump scheme in which they made misleading statements to boost the price of the securities. *See* SEC Br. 50-51. The case had been submitted on two theories: that the misleading statements were deceptive, and that the defendants had breached the fiduciary duty they owed to the investors. The court found that the fiduciary duty instruction was defective, so that the verdict could not be affirmed on that basis, but nonetheless upheld the conviction on the basis of the misstatement theory. It is difficult to imagine a better illustration of the Commission's contention that a violation of Section 10(b) can occur even without a breach of fiduciary duty. In response, Dorozhko describes the course of proceedings but never comes to terms with the case's holding, and then asserts that the case is not relevant because it does

not cite *Dirks*, *Chiarella*, or *O'Hagan*. Br. 30. To the contrary, the fact that these cases are not cited is telling evidence that they are not relevant.

**Manipulations.** In *ATSI Comm., Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99-100 (2d Cir. 2007), this Court held that market manipulation violates Rule 10b-5 "regardless of whether there is a fiduciary relationship between transaction participants." *See* SEC Br. 52-53. Dorozhko responds that "[m]anipulative as used in Rule 10(b) is a term of art that has been given a specific meaning," and that manipulation is a different concept from "deception." Br. 30-31. The holding of *ATSI* , however, is not that manipulation is "manipulative," but that manipulation is "deceptive." Section 10(b) authorizes the Commission to adopt rules forbidding both "manipulative" and "deceptive" devices. Rule 10b-5 forbids fraudulent conduct but does not use the word "manipulative." This Court concluded that Rule 10b-5 nonetheless prohibits market manipulation because manipulation involves "willful conduct designed to *deceive* or defraud investors by controlling or artificially affecting the price of securities," 493 F.3d at 100 (quoting *Hochfelder*, 425 U.S. at 199) (emphasis added), and that

Rule 10b-5 required a showing that the manipulation was "aimed at *deceiving* investors," *id.*

**b. Other decisions, including those from four other circuits, also hold that breach of fiduciary duty is not required when a defendant engages in active deception.**

Another decision from this Circuit is *Caiola v. Citibank*, 295 F.3d 312, 331 (2d Cir. 2002), where a customer brought a securities fraud claim against his bank alleging "material misrepresentations concerning [the bank's investment] strategy." The bank argued that the customer failed to state a claim because he was told that the bank "would not be his fiduciary or advisor." *Id.* This Court rejected the bank's argument, holding that "the lack of an independent duty" to disclose its hedging strategy "is not, under such circumstances, a defense to Rule 10b-5 liability because upon choosing to speak, one must speak truthfully about material issues." *Id.*[12]

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[12] This Court cited, *inter alia, Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263, 267-68 (6th Cir. Cir. 1998) (even if an attorney representing the seller in a securities transaction does not have an "independent duty" to volunteer information to a prospective buyer, "he assumes a duty to provide complete and non-misleading information with respect to subjects on which he undertakes to speak"), and *Ackerman v. Schwartz,* 947 F.2d 841, 848 (7th Cir. 1991) (distinguishing *Chiarella* on the ground that "the lack of an independent duty does not excuse a material lie," citing *Basic*).

Similarly, in *Semerenko v. Cendant Corp.*, 223 F.3d 165, 187 n.14 (3d Cir. 2000) the court declined to dismiss plaintiffs' claims on the asserted ground that plaintiffs had not alleged breach of a fiduciary duty. The court explained that *Chiarella* and *Dirks* apply to allegations "that the defendants failed to disclose material facts," but noted that "[t]hough defendants who are neither fiduciaries nor insiders generally are not under a duty to disclose material information, they subject themselves to liability under §10(b) and Rule 10b-5 when they make affirmative misrepresentations."

The issue has come up several times in the context of options trading. For instance, in *Fry v. UAL Corp.,* 84 F.3d 936, 937-38 (7th Cir. 1996) (Posner, J.), the issuer of the underlying stock argued that it could not be held liable under Section 10(b) for misrepresentations affecting the owners of options on its stock because an issuer does not have a fiduciary duty to options holders. The court agreed that there was no fiduciary obligation, but rejected defendant's argument that this was a valid defense. It distinguished *Chiarella* because the "duty not to make misrepresentations does not depend on the existence of a fiduciary relationship," *citing Basic*, 485 U.S. at 240 n.18. Otherwise, the court observed, "very little fraud

would be actionable. The garden-variety fraud in which the seller of a product misrepresents its qualities to the buyer would not be, because a seller is not his buyer's fiduciary." *Id.* [13]

### C. The fact that Rule 14e-3, which prohibits certain trading in connection with tender offers, does not require a breach of fiduciary duty has no bearing on whether Section 10(b) imposes a fiduciary requirement in cases of affirmative misstatement.

Dorozhko makes a confused argument that the Commission's adoption in 1980 of Rule 14e-3 under Section 14(e) of the Exchange Act somehow proves that Section 10(b) requires a breach of fiduciary duty. Br. 32-35. In contrast to Section 10(b), which prohibits only conduct contrary to Commission rules or regulations, Section 14(e) has a self-operative

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[13] Other decisions reaching the same conclusion in the options context are *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 506 (3d Cir. 1988), *cert. denied*, 490 U.S. 1114 (1989) (*Chiarella* and *Dirks* are "simply not relevant to the distinct issue of affirmative misrepresentations affecting a market in securities" because "[n]othing in those opinions . . . can be construed to require the existence of a fiduciary relationship between a section 10(b) defendant and the victim of that defendant's affirmative misrepresentation"), and *Backman v. Polaroid Corp.*, 893 F.2d 1405, 1429-30 (1st Cir. 1990) ("plaintiffs' arguments on appeal focus on allegedly misleading statements" that constituted "misleading conduct," "the issue of affirmative misrepresentations is distinct from the context of insider trading, and presents a situation where . . . the language of *Chiarella* do[es] not apply").

provision that directly prohibits misleading statements and fraudulent, deceptive and manipulative practices in connection with any tender offer without the need for Commission rulemaking. See *O'Hagan*, 521 U.S. at 671-72.[14] Section 14(e) also has a rulemaking provision that gives the Commission authority to adopt rules and regulations that "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

Acting pursuant to the rulemaking authority, the Commission has adopted Rule 14e-3, which imposes a disclose or abstain requirement on those in possession of certain nonpublic information in connection with a tender offer. The details of the Rule are not important here. All that is relevant to Dorozhko's argument is that breach of a fiduciary duty is not an element of a violation Rule 14e-3. Instead, all that need be shown under Rule 14e-3 is that the defendant had the specified nonpublic information and that he traded without disclosing. *See O'Hagan,* 521 U.S. at 669

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[14] Section 14(e) and Rule 14e-3 are reproduced in the Addendum to this brief.

(upholding Rule 14e-3 as a means reasonably designed to prevent fraudulent, deceptive or manipulative acts and practices).

Dorozhko claims that the Commission adopted Rule 14e-3 because it perceived *Chiarella* as "limiting Rule 10(b)'s scope to situations in which the trading party breached a duty of trust," including, Dorozhko believes, situations where there have been affirmative misrepresentations. Br. 34. To the contrary, Rule 14e-3 is not at all concerned with cases in which someone has engaged in affirmative deception. Rather, the Rule was adopted to address situations in which there is a failure to make disclosure. Specifically, Rule 14e-3 was adopted as a prophylactic measure because trading without disclosure in breach of a fiduciary duty is particularly likely in the context of a tender offer, and also unusually difficult to prove given that there are often a fairly wide circle of people with confidential information. *See O'Hagan*, 521 U.S. at 674-676; *United States v. Chestman,* 947

F.2d 551, 559(2d Cir. 1991) *(en banc)*, *cert. denied*, 503 U.S. 1004 (1992).[15]

These concerns are not implicated when a defendant engages in affirmative deceptive conduct, and adoption of Rule 14e-3 sheds no light on the law applicable to misstatements. Thus, the Commission explained in the Adopting Release for Rule 14e-3 that "[t]he Court's analysis in *Chiarella* does not alter existing standards of liability under Section 10(b) and Rule 10b-5 in cases where the defendant has made affirmative statements in connection with the purchase or sale of a security." *Tender Offers*, Exchange Act Rel. 33-6239 & 34-17120, 45 Fed. Reg. 60410, at n.9 (1980). Both before and after *Chiarella,* affirmative deception in connection with a tender offer is covered by the self-operative portion of Section 14(e), while an affirmative misrepresentation in connection with the purchase or sale of securities (including purchases and sales involving tender offers) is prohibited by Section 10(b) and Rule 10b-5, with no requirement for a

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[15] Even the academic source that Dorozhko quotes to advance his Rule 14e-3 argument (Opp. at 34-35) does not agree that a breach of fiduciary duty is a necessary condition under Rule 10b-5, but instead notes that Rule 10b-5 had "its genesis in the common law tort of deceit," and a person "committed the tort of deceit under common law if they affirmatively misrepresented material facts." *See* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 Gonz. L. Rev. 181, 187 n.31 (2005-06).

breach of fiduciary duty under either Section. *See, e.g., SEC v. Bilzerian*, 29 F.3d 689, 695 (D.C. Cir. 1994) (affirming that a defendant who made misrepresentations in his tender offer violated both Section 10(b) and Section 14(e) even though his securities laws violations "did not arise from a position of authority in a brokerage firm, or from any other position for that matter . . . [t]hey resulted from actions he took *as an investor*") (original emphasis); *Billard v. Rockwell Intern. Corp*., 683 F.2d 51, 56-57 (2d Cir. 1982) (noting that there could be viable claims under both Sections 10(b) and 14(e) for misrepresenting that experts have advised the offeror that a tender offer price is fair).

## CONCLUSION

For the foregoing reasons, and for the reasons set forth in the Commission's opening brief, if this Court agrees both that a breach of fiduciary duty is not always required under Section 10(b) and that hacking is deceptive, this Court should direct the district court to grant a preliminary injunction and continue the asset freeze. Alternatively, if this Court decides not to review the issue of whether hacking is deceptive, but

agrees that Section 10(b) can be violated absent a breach of fiduciary duty, this Court should reverse the district court's denial of a preliminary injunction, remand for the district court to consider the deception issue in the first instance, and keep the asset freeze in effect pending the district court's consideration of that issue.

Respectfully submitted,

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August 2008

## CERTIFICATE OF COMPLIANCE
**Pursuant to Fed. R. App. P. 32(a)(7)(C)**

I hereby certify that, pursuant to Fed. R. App. P. 32(a)(7)(C), the attached brief is proportionately spaced, has a typeface of 14 points or more, and contains 6,507 words.

Dated: August 4, 2008

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# ADDENDUM

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## Section 14(e), 15 U.S.C. 78n(e)

(e) Untrue statement of material fact or omission of fact with respect to tender offer

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, 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.

**Rule 14e-3, 17 C.F.R. 240.14e-3**

Transactions in securities on the basis of material, nonpublic information in the context of tender offers.

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

(b) A person other than a natural person shall not violate paragraph (a) of this section if such person shows that:

(1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) of this section or to cause any such security to be purchased or sold by or on behalf of others did not know the material, nonpublic information; and

(2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a) of this section, which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(c) Notwithstanding anything in paragraph (a) of this section to contrary, the following transactions shall not be violations of paragraph (a) of this section:

(1) Purchase(s) of any security described in paragraph (a) of this section by a broker or by another agent on behalf of an offering person; or

(2) Sale(s) by any person of any security described in paragraph (a) of this section to the offering person.

(d)

(1) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section except that this paragraph shall not apply to a communication made in good faith,

(i) To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer;

(ii) To the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or

(iii) To any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

(2) The persons referred to in paragraph (d)(1) of this section are:

(i) The offering person or its officers, directors, partners, employees or advisors;

(ii) The issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or advisors;

(iii) Anyone acting on behalf of the persons in paragraph (d)(2)(i) of this section or the issuer or persons in paragraph (d)(2)(ii) of this section; and

(iv) Any person in possession of material information relating to a tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from any of the above.