
No. 04-55665

IN THE
United States Court of Appeals
FOR THE NINTH CIRCUIT

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

Plaintiff,

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM,

Plaintiff-Appellant,

v.

HOMESTORE.COM, INC., *et al.*,

Defendants-Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF CALIFORNIA
D.C. No. CV-01-11115-MJP

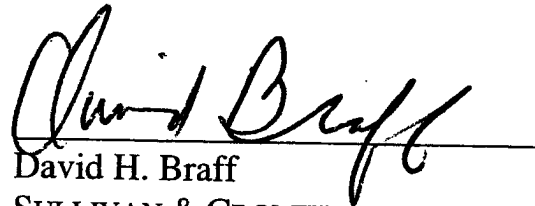
**BRIEF OF THE BOND MARKET ASSOCIATION, THE CHAMBER OF
COMMERCE OF THE UNITED STATES, THE CLEARING HOUSE
ASSOCIATION L.L.C. AND THE SECURITIES INDUSTRY ASSOCIATION,
AS *AMICI CURIAE*, IN SUPPORT OF DEFENDANTS-APPELLEES AND
AFFIRMANCE**

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 26.1 and 29, the undersigned counsel for The Bond Market Association, the Chamber of Commerce of the United States, the Clearing House Association L.L.C. and the Securities Industry Association hereby certifies that these organizations are not subsidiaries of any other corporation, and that no publicly held corporation owns 10% or more of the stock of these organizations.



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Pursuant to Federal Rule of Appellate Procedure 29, The Bond Market Association (the “BMA”), the Chamber of Commerce of the United States (“Chamber”), the Clearing House Association L.L.C. (“Clearing House”) and the Securities Industry Association (“SIA”) (collectively, the “*Amici*”) respectfully submit this brief as *amici curiae* in support of Defendants-Appellees Cendant Corporation, L90, Inc. d/b/a MaxWorldwide, Inc. and Time Warner, Inc. (“Appellees” or the “Business Defendants”), to urge that the Court affirm the judgment below and to address the proper scope of primary liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Plaintiff-Appellant and the Defendants-Appellees have consented to the filing of this *amicus curiae* brief.

INTEREST OF THE *AMICI CURIAE*

The BMA represents approximately 200 securities firms and banks that underwrite, trade and sell fixed-income securities in the United States and in international markets. The BMA’s membership comprises a diverse mix of securities firms and banks, including large, multi-product firms and companies with special market niches. Its members include all primary dealers in U.S. government securities and all major dealers in

federal agency securities, mortgage-backed and asset-backed securities, corporate bonds, money market instruments and funding instruments such as repurchase and securities lending agreements. The BMA files *amicus curiae* briefs in cases raising issues of importance to fixed-income securities markets.

The Chamber is the world's largest business federation. The Chamber represents an underlying membership of more than three million businesses and organizations of every size, in every industry sector, and from every region of the country. The Chamber regularly advocates the interests of its members, including as *amicus curiae*, in cases involving issues of national concern to the American business community.

The Clearing House was founded over 150 years ago and is an association of leading commercial banks in the United States that provides payment, clearing and settlement services to its member banks and to other financial institutions. The Clearing House regularly appears as *amicus curiae* in cases that present issues of importance to the commercial banking industry.

SIA brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and

maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers and mutual fund companies) are active in U.S. and foreign markets and in all phases of corporate and public finance. SIA routinely files *amicus curiae* briefs addressing issues of importance to the securities industry.

The *Amici* submit this brief because the issue presented by this appeal — namely, what conduct may give rise to primary liability under Section 10(b) and Rule 10b-5 subsequent to the Supreme Court’s decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) — is of great importance to the members of the *Amici*. The members of the *Amici* collectively engage in many thousands of transactions each year involving publicly traded companies. As a result, it is critically important to the *Amici* that their members are not exposed to private liability under Section 10(b) and Rule 10b-5 where they have engaged in commercial transactions with an issuer and it is alleged that the issuer has misreported or misrepresented such transactions in its financial statements, and, more generally, that there be the clear, distinct guidelines concerning liability that the Supreme Court has repeatedly held are essential for Section 10(b) and

Rule 10b-5. *See, e.g., Central Bank*, 511 U.S. at 188-89; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975).

In the absence of statements or actions by a secondary actor that are relied upon by investors in connection with transactions in the issuer-counterparty's securities, there cannot be a primary violation of Section 10(b) because at least two required elements of such a violation are absent: (1) the secondary actor's conduct (*i.e.*, a transaction with the issuer) is not "in connection with" any securities transaction, and (2) *a fortiori*, investors have not relied on the secondary actor's conduct. Claims by private plaintiffs against the secondary actors in such cases are, at the most, aiding and abetting claims barred by *Central Bank*. Indeed, as the District Court here observed, a contrary conclusion "would broaden the scope of the securities acts so as to haul into court anyone doing business with a publicly traded company." *In re Homestore.com, Inc. Secs. Litig.*, 252 F. Supp. 2d 1018, 1039 (C.D. Cal. 2003).

The *Amici* also have an important interest in ensuring that Congress's decisions concerning the application of Section 10(b) are faithfully observed. Following *Central Bank*, Congress was confronted with two basic issues. First, Congress was urged by the Securities and Exchange

Commission (“SEC”) and others to overturn *Central Bank*. Second, there was uncertainty as to whether the *Central Bank* dichotomy between primary conduct and aiding and abetting applied to enforcement actions by the SEC as well as to private litigation.

Congress dealt directly with both issues in the Private Securities Litigation Reform Act of 1995 (“PSLRA”). Congress reaffirmed the SEC’s authority to bring actions against persons who knowingly aid and abet primary violations of Section 10(b). *See* 15 U.S.C. § 78t(e). Alarmed, however, by the explosion of meritless private litigation and its adverse effect on individual companies and the economy as a whole, Congress specifically declined to give private plaintiffs similar authority, because “private aiding and abetting liability actions under Section 10(b) would be contrary to S. 240’s goal of reducing meritless securities litigation.” S. REP. NO. 104-98, at 19 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 698.¹ The *Amici* urge this Court to respect that Congressional determination by affirming the decision below.

¹ Congress decided not to give private plaintiffs this authority even though the SEC argued that Congress should “fully restore the aiding and abetting liability eliminated in the Supreme Court’s *Central Bank of Denver* opinion.” S. REP. NO. 104-98, at 48, *reprinted in* 1995 U.S.C.C.A.N. 679, 727.

ARGUMENT

It is essential at the outset to set forth both what this case is about and what it is not about. This case is not about the SEC's ability to enforce Section 10(b) and Rule 10b-5. Congress made clear in the PSLRA that *Central Bank* does not limit the SEC's enforcement authority based on the distinction between primary violators and aiders and abettors. The SEC is authorized to take enforcement action against both, and, therefore, affirmance of the decision below will not stand for the proposition that alleged aiders and abettors are immune from action by the SEC.²

What this case is about is the boundaries of the distinction between a primary violator, against whom a private right of action exists, and an aider and abettor, against whom it does not. The words of Section 10(b) and Rule 10b-5, as reinforced by the Supreme Court in *Central Bank* and by Congress, make clear that only the company that publishes inaccurate

² As the Supreme Court noted in *Central Bank*, “[t]o be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances. The issue, however, is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.” 511 U.S. at 177 (citation omitted); *see also In re Homestore*, 252 F. Supp. 2d at 1041 (“This decision does not mean that the wrongs of these aiders and abettors will necessarily go unchecked; the PSLRA expressly granted the SEC the authority to bring civil actions against aiders and abettors of securities fraud, and it is this Court’s understanding that some investigation is ongoing.”).

or misleading financial statements or the company that commits a manipulative act in connection with a securities transaction is a primary violator. Any other conclusion will inevitably result in the explosion of meritless securities litigation that Congress sought to prevent.

In *Central Bank*, the Supreme Court unequivocally held that no private right of action for aiding and abetting exists under Section 10(b). See 511 U.S. at 191. Perhaps anticipating the efforts of private litigants to circumvent *Central Bank* by seeking to expand the concept of “primary violator,” the Supreme Court emphasized that there may be liability in private litigation under Section 10(b) and Rule 10b-5 only if “*all* of the requirements for primary liability under Rule 10b-5 are met.” *Id.* (emphasis in original). In other words, the Supreme Court held that, to state an actionable claim under those provisions, private plaintiffs must plead and prove *each element* of a primary violation of Section 10(b) and Rule 10b-5 *as to each defendant* based on each defendant’s conduct.

Although the Supreme Court in *Central Bank* was not called upon to articulate the distinction between primary violations of Section 10(b) and aiding and abetting such violations, it did provide clear guidance

as to the proper distinction based upon its prior decisions under Section 10(b) and Rule 10b-5. There are three key guidelines.

First, there must be “adherence to the statutory language.”

Central Bank, 511 U.S. at 173 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring); *Chiarella v. United States*, 445 U.S. 222, 226 (1980); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977)). The Supreme Court declined to “amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.” *Central Bank*, 511 U.S. at 177-78.

Second, this is “an area that demands certainty and predictability.” *Id.* at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). Unclear rules “lead[] to the undesirable result of decisions ‘made on an ad hoc basis, offering little predictive value’ to those who provide services to participants in the securities business.” *Central Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652). “[S]uch a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5’ is not a ‘satisfactory basis for a rule of liability

imposed on the conduct of business transactions.” *Central Bank*, 511 U.S. at 188 (quoting *Blue Chip Stamps*, 421 U.S. at 755) (alterations in original).

Third, the distinction should be drawn in a way that recognizes that “litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.” *Central Bank*, 511 U.S. at 189 (quoting *Blue Chip Stamps*, 421 U.S. at 739). The Supreme Court noted the “ripple effects” of excess litigation under Rule 10b-5 on newer and smaller companies, professionals and ultimately investors. *Central Bank*, 511 U.S. at 189.

This third guideline is not merely reinforced, but explicitly imposed, by Congress in the PSLRA. Congress determined that the interests of our capital markets were best served by preventing the meritless litigation that would inevitably accompany an expansion of private liability under Section 10(b) and Rule 10b-5 to include aiding and abetting. As set forth in the House Report, the PSLRA was designed “to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation.” H.R. REP. NO. 104-369, at 31-32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731. Congress could afford to make this decision

because, at the same time, it reaffirmed the SEC's authority to bring actions for aiding and abetting.

The positions advocated by Plaintiff-Appellant ("Plaintiff") and its *amici*, the SEC and the Regents of the University of California (the "Regents"), are contrary to each of these guidelines.

Despite *Central Bank*'s clear ruling, Plaintiff in the case at bar and plaintiffs in numerous other actions have asserted that financial institutions and other business entities may be liable for primary violations of Section 10(b) and Rule 10b-5 when they have engaged in commercial transactions with companies that have allegedly published inaccurate or misleading financial statements.³ What the plaintiffs ignore in each of these cases is that the issuer can (1) account for and represent the transactions in a way that is in accordance with generally accepted accounting principles and the issuer's other disclosure obligations, or (2) account for the transactions improperly or otherwise misrepresent them. It is the issuer's decision — and

³ One of the most prominent examples of such a case is the Enron Corp. securities litigation pending in the United States District Court for the Southern District of Texas (the "*Enron* Litigation"). *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, Civ. A. No. H-01-3624 (S.D. Tex.). Some of the members of one or more of the *Amici* have been named as defendants in the *Enron* Litigation. The Regents, which submitted its own *amicus curiae* brief here, has been appointed Lead Plaintiff in the *Enron* Litigation.

its alone — as to which course to take. If it elects the first, there is no harm to investors. If it elects the second, it is the primary violator who has caused harm to the investors. In this scenario, the counterparty may have aiding and abetting liability in an SEC enforcement action (assuming that the elements of that violation are established). It is the issuer alone, however, that is the primary violator of Section 10(b) and Rule 10b-5 as a result of its decision to publish inaccurate or misleading financial statements.

Seeking to circumvent *Central Bank* and its Congressional reaffirmation, plaintiffs in many recently filed cases attempt to mask the claims against these secondary actors as primary violations of Section 10(b) by contending that the transactions themselves are “manipulative or deceptive devices” in furtherance of a “scheme to defraud” under Rule 10b-5(a) or (c). In other words, plaintiffs seek to recast aiding and abetting claims as primary violations of Section 10(b) by alleging that all the defendants participated in a “scheme to defraud.” Simply invoking the language of the Rule, however, does not establish primary liability. Instead, as the Supreme Court observed in *Central Bank*, in order to establish primary liability under Section 10(b) against a particular defendant, a private

plaintiff must plead and prove *each* element of primary liability under Section 10(b) as to that defendant based on that defendant's own conduct.

Plaintiff's conclusory invocation of "scheme" liability is fundamentally flawed because it ignores the critical distinction between primary liability under Section 10(b) and private aiding and abetting liability barred by *Central Bank*. Primary liability under Section 10(b) attaches only where the defendant's alleged conduct is (among other things) (i) in connection with the purchase or sale of a security, and (ii) relied upon by the investor engaging in the securities transaction (either directly or by proper application of the fraud-on-the-market presumption). Where a defendant's alleged conduct is one or more steps removed from the pertinent securities transactions by the allegedly defrauded investors, a plaintiff is unable to plead and prove each element of a Section 10(b) and Rule 10b-5 violation with respect to that defendant. As shown below, in this case, there was no connection between the alleged conduct of the Business Defendants who engaged in commercial transactions with the issuer (*i.e.*, Homestore) and the pertinent securities transactions by investors after Homestore published allegedly false financial statements. Accordingly, regardless of how

Plaintiff characterizes its claim against the Business Defendants, Plaintiff cannot plead and prove a primary violation of Section 10(b) by them.

In a transparent effort to bring the conduct of the Business Defendants within the scope of primary liability under Section 10(b) and Rule 10b-5, the Plaintiff and the SEC and the Regents, as *amici curiae*, propose broad and ambiguous standards for primary liability that directly contradict the holding, the rationale and the guidelines of *Central Bank*, as well as Congress's clearly expressed intentions in the PSLRA. As discussed *infra* in Section II, the Court should reject these proposed standards because they ignore the specific requirements of Section 10(b) and Rule 10b-5, and thus would effectively eliminate the distinction between primary liability and private aiding and abetting liability barred by *Central Bank*. In addition, these standards are so ill-defined they would run a serious risk of chilling legitimate business activity.

Shortly after *Central Bank* and the PSLRA, this Court had occasion to reiterate the standard of aiding and abetting liability. The Court held that the elements of an aiding and abetting violation are: "(1) the existence of an independent primary violation; (2) actual knowledge by the alleged aider and abettor of the primary violation and of his or her own role

in furthering it; and (3) ‘substantial assistance’ by the defendant in the commission of the primary violation.” *SEC v. Fehn*, 97 F.3d 1276, 1288 (9th Cir. 1996) (citing *Hauser v. Farrell*, 14 F.3d 1338, 1343 (9th Cir. 1994)). Private litigants cannot evade the fundamental distinction between primary liability and aiding and abetting liability by alleging the very same conduct that constitutes “aiding and abetting” also constitutes a “primary violation.” There must be something that is more than “actual knowledge” and “substantial assistance,” and the “more” is lacking in this case. *See Wright v. Ernst & Young LLP*, 152 F.3d 169, 176 (2d Cir. 1998) (allegations of “mere knowledge and assistance in the fraud” are insufficient to state a Section 10(b) and Rule 10b-5 claim); *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) (“[a]llegations of ‘assisting,’ ‘participating in,’ ‘complicity in’ and similar synonyms . . . all fall within the prohibitive bar of *Central Bank*”); *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) (“The Court’s rationale [in *Central Bank*] precludes a private right of action for ‘conspiracy’ liability.”); *Stack v. Lobo*, 903 F. Supp. 1361, 1374 (N.D. Cal. 1995) (dismissing Section 10(b) claims because plaintiffs’ “scheme allegations [are] no more than a thinly disguised attempt to avoid the impact of the *Central Bank* decision”); *In re Valence Tech. Sec. Litig.*, No. C 95-

20459 JW, 1996 WL 37788, at *10-11 (N.D. Cal. Jan. 23, 1996) (“Courts have dismissed claims alleged as ‘schemes’ on the grounds that they were merely non-actionable conspiracy claims that had been recharacterized.”).

In short, after *Central Bank*, a defendant can be liable as a primary violator only if a private plaintiff establishes *each* element of Section 10(b) and Rule 10b-5 as to that defendant, *without regard to the conduct of other defendants*. See *Central Bank*, 511 U.S. at 191. As correctly stated by the District Court in the case at bar: “What is clear, however, is that *Central Bank* requires a plaintiff to allege that each and every defendant committed *its own independent primary violation* of securities laws in order to state a claim.” *In re Homestore*, 252 F. Supp. 2d at 1040 (emphasis added). Short of such a showing, a plaintiff cannot establish primary liability under Section 10(b) and Rule 10b-5. A defendant, however, may still be answerable to the SEC for aiding and abetting a Section 10(b) and Rule 10b-5 violation or conspiracy to commit such a violation (assuming that the standards for that liability can be established).

I. PRIMARY LIABILITY UNDER SECTION 10(b) AND RULE 10b-5 ATTACHES ONLY IF A PLAINTIFF PLEADS AND PROVES EACH ELEMENT OF THOSE VIOLATIONS AS TO EACH DEFENDANT.

Regardless of whether the Business Defendants are characterized as primary or secondary actors, or whether Plaintiff's claims against the Business Defendants are labeled Rule 10b-5(b) claims or Rule 10b-5(a) or (c) claims, the District Court here correctly dismissed those claims. As shown below, Plaintiff failed to plead adequately each element of a Section 10(b) and Rule 10b-5 violation as to each Business Defendant. *See* 252 F. Supp. 2d at 1040. Specifically, Plaintiff failed to allege that the Business Defendants' conduct was "in connection with" the purchase of any Homestore security. Likewise, Plaintiff failed to allege reliance by investors on the conduct of the Business Defendants in deciding to purchase Homestore securities. Under *Central Bank's* dictates, these failures are dispositive.

A. A Defendant Cannot Be Liable for a Primary Violation of Section 10(b) and Rule 10b-5 Unless Its Statements or Actions Occurred in Connection with the Purchase or Sale of Securities.

Section 10(b) liability attaches only to those who "use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b).

Under Rule 10b-5(a) and (c), it is unlawful to employ any device, scheme or artifice to defraud *in connection with* the purchase or sale of any security, or to engage in any act that would operate as a fraud in connection with the purchase or sale of any security. *See* 17 C.F.R. § 240.10b-5(a) & (c).

Although the Supreme Court in *Central Bank* held that “secondary actors in securities markets . . . including a lawyer, accountant, or bank . . . may be liable as a primary violator under Rule 10b-5,” it also made clear that such liability may attach only if a plaintiff pleads and proves that the conduct of such secondary actors independently satisfies *each* element of a violation of Section 10(b) and Rule 10b-5.⁴ *Central Bank*, 511 U.S. at 191. In order to state a claim under these sections, a plaintiff must plead that a defendant (1) engaged in conduct proscribed by Rule 10b-5; (2) in connection with the purchase or sale of security; (3) with scienter; (4) upon which conduct the plaintiff reasonably relied; and (5) which conduct caused the alleged loss. *See Broudo v. Dura Pharm., Inc.*, 339 F.3d 933, 937 (9th Cir. 2003), *cert. granted*, 124 S. Ct. 294 (2004); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1485 (9th Cir. 1991).

⁴ The *Central Bank* standard applies equally to material misrepresentations and omissions prohibited by Rule 10b-5(b) and to “manipulative” or “deceptive” acts prohibited by Rule 10b-5(a) and (c). *See Central Bank*, 511 U.S. at 171-72, 180.

The Supreme Court recently addressed the “in connection with” requirement in *SEC v. Zandford*, 535 U.S. 813 (2002). In holding that this requirement had been satisfied there, the Supreme Court explained:

The securities sales and respondent’s fraudulent practices were not independent events. This is not a case in which, after a lawful transaction had been consummated, a broker decided to steal the proceeds and did so. . . . Rather, *respondent’s fraud coincided with the sales themselves*.

Id. at 820 (emphasis supplied); *see also United States v. O’Hagan*, 521 U.S. 642, 656 (1997) (holding trading on misappropriated information met the “in connection with” requirement because “[t]he securities transaction and the breach of duty thus coincide[d]”).

In the case at bar, the Business Defendants’ alleged fraudulent conduct — the transactions executed with Homestore that were later allegedly misreported by Homestore — was not in connection with the purchase or sale of any security. Tellingly, Plaintiff, the SEC and the Regents fail to even mention the “in connection with” requirement in their respective briefs. That omission is glaring because the Business Defendants’ transactions — as distinguished from Homestore’s alleged misreporting of those transactions in its financial statements — were independent events that did not deceive any Homestore investors or even touch upon any purchase of

Homestore securities. Rather, it was the alleged, *subsequent* public misrepresentations in Homestore's financial statements — and only those misrepresentations — that deceived investors who bought Homestore securities after the financial statements were published. Indeed, this is precisely the type of situation that the Supreme Court was distinguishing in *Zandford* when it indicated that the “in connection with” requirement would not have been met if the fraud had occurred “after a lawful transaction had been consummated.” 535 U.S. at 820. Here, certain lawful transactions were consummated and then, similar to the hypothetical broker contemplated in the Supreme Court's example, Homestore decided to misrepresent these transactions to the public.⁵ It was only the alleged misrepresentations by Homestore that “coincided” with the sale of

⁵ There is a critical distinction between a “manipulative device” under Section 10(b) and a device that may be manipulated by others. Assuming that the Business Defendants' transactions can be characterized as “devices” at all, as the Business Defendants explain in their respective briefs, these transactions were not inherently manipulative — indeed, the transactions themselves did not deceive a single Homestore investor. (*See, e.g.*, Time Warner Br. at 47-54.) Any alleged manipulation occurred only when Homestore purportedly accounted for and reported the transactions improperly. Although Plaintiff may argue that the transactions in question were “devices,” they were not “manipulative devices” within the meaning of Section 10(b) and Rule 10b-5.

Homestore securities, and it was those misrepresentations by which the securities fraud was allegedly perpetrated.

This conclusion is supported by a recent decision from the United States District Court for the Southern District of Texas in *In re Dynegy, Inc. Secs. Litig.*, 339 F. Supp. 2d 804 (S.D. Tex. 2004). The plaintiff in that action alleged that Citigroup had structured and funded transactions to conceal debt from Dynegy's balance sheet, and to inflate Dynegy's reported income and cash flows. Applying the holding of *Zandford*, and focusing directly on the "in connection with" requirement, the court concluded that "[b]ecause plaintiffs in this case do not allege any facts showing that Citigroup's allegedly manipulative and deceptive acts coincided with sales of Dynegy securities, . . . the facts of this case are distinguishable from those in which courts have found defendants' acts to constitute a manipulative or deceptive device or fraud that is actionable under § 10(b)." *Id.* at 916. The court also found that "the aid that Citigroup provided Dynegy is not actionable under § 10(b), and plaintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent *Central Bank's* limitations on liability for a secondary actor's involvement in the preparation of false and misleading statements." *Id.*

Just as in *Dynegy*, here the Business Defendants’ alleged acts did not coincide with purchases of Homestore securities by the putative class members. As the court in *Dynegy* and the District Court here understood, private plaintiffs’ claims must be dismissed where they assert only that secondary actors have engaged in conduct one or more steps removed from the relevant securities transactions, because such claims do not satisfy Section 10(b)’s “in connection with” requirement.

B. A Defendant Cannot Be Liable for a Primary Violation of Section 10(b) and Rule 10b-5(a) or (c) Unless the Plaintiff Pleads and Proves Reliance as to That Defendant.

The Supreme Court in *Central Bank* reasoned that aiding and abetting liability would eviscerate the reliance element under Section 10(b) and Rule 10b-5 because “the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor’s statements or actions.” 511 U.S. at 180. The Court observed that “[a]llowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases.” *Id.*

Applying *Central Bank*, the District Court here correctly dismissed Plaintiff’s Section 10(b) and Rule 10b-5 claims against the Business Defendants because Plaintiff did not adequately plead that

Homestore investors relied on any statements or actions by those defendants. Indeed, Plaintiff purported to rely solely on Homestore's alleged misrepresentations concerning the transactions in which the Business Defendants had engaged before Homestore accounted for and reflected those transactions in publicly issued financial statements. There is no allegation, nor could there be, that a single investor relied on the transactions themselves. In fact, had Homestore properly accounted for the transactions, there would have been no alleged securities fraud at all. *See O'Hagan*, 521 U.S. at 655. The Business Defendants' participation in the transactions as counterparties to Homestore — without any affirmative act by the Business Defendants with respect to Homestore's investors — is not actionable by private litigants under Section 10(b) and Rule 10b-5.

Plaintiff tries to satisfy the reliance requirement with respect to the Business Defendants by arguing that investors relied on a "scheme" rather than "on [Homestore's] false and misleading statements." (Appellant Br. at 46.) This argument cannot withstand scrutiny. As is clear from Plaintiff's allegations, the alleged "scheme" in this case manifested itself to Homestore's investors only through alleged misstatements by Homestore, and not through any statements or conduct by the Business Defendants.

Because it is only Homestore's public statements to the marketplace that connect investors to the alleged "scheme," Plaintiff cannot plead or prove that investors relied on the Business Defendants at all. The Court should reject Plaintiff's attempt to use "scheme" allegations to bootstrap its reliance allegations against the Business Defendants.

Likewise, the "fraud-on-the-market" doctrine — which affords plaintiffs a presumption that investors relied on alleged misrepresentations or omissions because they were reflected in Homestore's stock price, *see Basic Inc. v. Levinson*, 485 U.S. 224, 245-47 (1988) — does not excuse Plaintiff from pleading that it relied on statements or conduct by the Business Defendants *themselves*. The only alleged fraud presented to the market here was in Homestore's statements, not the transactions executed with the Business Defendants. Thus, although the fraud-on-the-market presumption may serve as a proxy for investors' reliance upon Homestore's statements to the market, it does not allow a presumption that investors or the market relied upon any conduct by the Business Defendants.

Attempting to cast the Rule 10b-5 net even more widely and achieve what was denied by the Supreme Court and Congress, the SEC in its *amicus* brief contends that 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 transactions." (SEC Br. at 21 (emphasis added).) The SEC's "flowing from" test would eliminate any meaningful distinction between primary liability under Section 10(b) and aiding and abetting liability. As discussed above, the Supreme Court in *Central Bank* held that private aiding and abetting claims cannot lie under Section 10(b) precisely because a plaintiff must prove reliance on a defendant's acts or statements. *See* 511 U.S. at 180. The SEC's "flowing from" test contravenes this central tenet of *Central Bank* because the deception resulting from a primary violator's actionable conduct can virtually always be viewed in some sense as "flowing from" an aider and abettor's actions. The Court should reject the SEC's "flowing from" test.

II. THE ADDITIONAL STANDARDS OF SECTION 10(B) LIABILITY PROPOSED BY PLAINTIFF, THE SEC AND THE REGENTS ARE INCONSISTENT WITH *CENTRAL BANK*, THE STATUTE AND CONGRESSIONAL INTENT.

Plaintiff, the SEC and the Regents propose various standards for primary liability under Section 10(b) and Rule 10b-5 that are transparently designed to render actionable the conduct of the Business

Defendants and many other counterparties, but at the expense of ignoring the specific requirements of Section 10(b) and Rule 10b-5, the mandate of *Central Bank* and Congress's clear objectives in the PSLRA. The Court should reject these standards because they effectively eliminate any distinction between primary liability under Section 10(b) and private aiding and abetting liability, and thus would permit courts to impose private aiding and abetting liability even though Congress has decided that only the SEC is authorized to bring such claims. These standards also fail to meet each of *Central Bank's* three guidelines: they do not comport with the statutory language; they do not provide precision and clarity; and they encourage, rather than curb, vexatious litigation. In order to preserve the Congressionally mandated distinction between primary liability and private aiding and abetting liability, the Court should abide by a standard that requires private plaintiffs to plead and prove *each* element of a primary violation of Section 10(b) and Rule 10b-5 *as to each defendant* based on each defendant's conduct.

Plaintiff argues that the Business Defendants are primarily liable because they "substantially participated" in a scheme to defraud in violation of Rule 10b-5(a) and in a course of business that operated as a

fraud in violation of Rule 10b-5(c). (See Appellant’s Br. at 37-39.)

Plaintiff’s proposed “substantial participation” standard is nothing more than aiding and abetting liability in disguise. This Court has repeatedly recognized that mere allegations of “participation,” “scheme to defraud,” and “conspiracy” amount to nothing more than prohibited aiding and abetting claims. See *In re GlenFed*, 60 F.3d at 592; *Stack*, 903 F. Supp. at 1374; *In re Valence*, 1996 WL 37788, at *10-11. Indeed, the SEC in its *amicus curiae* brief acknowledges that the “substantial participation” test is not appropriate in the “context of a scheme to defraud under Rule 10b-5(a).” (SEC Br. at 16 n.3.) Plaintiff’s proposed standard should be rejected because it is indistinguishable from the test for aiding and abetting liability available only to the SEC, and does not require, among other things, that the secondary actor’s conduct be relied on by the investors when transacting in securities, or be connected with any securities transaction.

The SEC’s proposed alternative to its “flowing from” standard — the “principal purpose and effect” test — is inherently subjective and ambiguous. It also fails to provide a meaningful basis to distinguish primary violations of Section 10(b) and Rule 10b-5 from aiding and abetting, and is therefore entirely at odds with the language of Section 10(b) and Supreme

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Court precedent. (See SEC Br. at 18-20).⁶ In its *amicus curiae* brief, the SEC argues that the Business Defendants' transactions with Homestore were manipulative or deceptive devices under Section 10(b) and Rule 10b-5 because their "principal purpose and effect is to create a false appearance of corporate revenues," and it is a "well-established principle that facts can be misrepresented by conduct as well as words." (*Id.* at 18-19.) In an effort to explain its proposed "principal purpose and effect" standard for liability under Section 10(b) and Rule 10b-5, the SEC states that "[i]f 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." (*Id.* at 19.)

⁶ The Court is not required to defer to the SEC's positions set forth in the SEC's *amicus* brief because those positions have been shaped for the purposes of litigation. See *Alaniz v. Office of Personnel Mgmt.*, 728 F.2d 1460, 1465 (Fed. Cir. 1984) ("no deference is due to an agency 'interpretation' fashioned for the purposes of litigation"); see also *Ames v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 567 F.2d 1174, 1177 n.3 (2d Cir. 1977) ("We cannot accept the Commission's current litigating position as an 'interpretation' by the Commission . . ."). Notably, in *Central Bank*, the Supreme Court rejected the SEC's position, advocated in an *amicus* brief, that "the use of the phrase 'directly or indirectly' in the text of § 10(b) covers aiding and abetting." 511 U.S. at 175; see also *Ernst & Ernst*, 425 U.S. at 197-99, 207 (rejecting SEC's interpretation of Section 10(b)).

By arguing that parties can “achieve the same deception through conduct rather than words” by acting “together,” and that this can be a primary violation of Section 10(b) and Rule 10b-5, the SEC’s proposed standard would allow plaintiffs to lump together the conduct of all defendants (by labeling it a “scheme”) and simultaneously cast aside *Central Bank*’s explicit requirement that each defendant’s conduct satisfy each element of Section 10(b) and Rule 10b-5. After *Central Bank*, it is simply not enough for a plaintiff to allege that parties acted together to “achieve the same deception.” Indeed, an aider and abettor (*i.e.*, one who gives aid to another) acts “together” with another to “achieve” deception. Yet, the aider and abettor’s conduct is not actionable as a primary violation of Section 10(b) and Rule 10b-5 because the plaintiff cannot satisfy each and every element of Section 10(b) and Rule 10b-5 as to that defendant.⁷

⁷ The SEC acknowledges as much in its rejection of the test for Rule 10b-5 liability announced in *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1998). In *Cooper*, the court noted 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.” *Id.* at 624 (emphasis added). As the SEC notes, the court’s use of the phrase “in furtherance of a scheme” connotes “assistance” and “thus suggests aiding and abetting.” (SEC Br. at 16 n.3.) Accordingly, the SEC submits that this Court should not use the

The SEC's own hypothetical scenarios, intended to demonstrate that its proposed standard "could appropriately distinguish between conduct to which primary liability should attach and mere aiding and abetting liability" (SEC Br. at 20), in fact demonstrate precisely the opposite. Thus, for example, the SEC claims that "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," and "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 or abettor." (*Id.*) In contrast, according to the SEC, if "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." (*Id.*) The SEC appears to draw a distinction in these hypothetical scenarios based on the scienter of the third party actor. The presence of scienter, however, cannot be the distinguishing feature between primary liability and aiding and abetting because it is a requirement of *both* violations.

The other hypothetical scenarios described by the SEC only add to the confusion of what precisely it is that the SEC is suggesting as the basis

Cooper test (and we concur), yet the SEC's "acting together" standard contains the same flaw.

on which to distinguish primary violations from aiding and abetting. For example, the SEC claims that 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 or abettor.” (*Id.* at 20 (emphasis added).) However, if “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.” (*Id.*) Although the distinction being drawn between the two hypotheticals is less than clear, it appears that the SEC is again focusing on intent, which is an untenable basis for distinction because it is required for an aiding and abetting violation.

In these hypothetical scenarios, the SEC also seemingly attempts to draw a distinction between “legitimate” and “illegitimate” transactions. Apparently, companies that use “legitimate” transactions to further a fraud are aiders and abettors; whereas, companies that engage in “illegitimate” transactions are primary violators of Section 10(b) and Rule 10b-5. This supposed distinction, however, is so inherently ambiguous that it could never provide a workable test to distinguish between aiding and

abetting liability and primary liability.. Indeed, the SEC does not even attempt to define “legitimate” transactions or explain how courts would apply this standard to separate aiding and abetting claims from primary violations. Under this proposed test, plaintiffs would only have to allege that the transaction in question was illegitimate (whatever that may mean), and the court would be powerless to dismiss the claim regardless of whether the investors relied on the defendant’s conduct or whether the alleged conduct was in connection with the securities transactions in question. Such a result is directly contrary to what Congress and the Supreme Court require.⁸ *See* S. REP. NO. 104-98, at 7, *reprinted in* 1995 U.S.C.C.A.N. 679, 686 (“If a defendant cannot win an early dismissal of the case, ‘the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.’” (quoting then-SEC Chairman Arthur Levitt)).

In sum, the SEC’s hypothetical scenarios only further blur, rather than clarify, the distinction between primary liability under Section 10(b) and aiding and abetting. This lack of clarity reflects a failure to recognize that the elements of primary liability under Section 10(b) are

⁸ The SEC’s final hypothetical suffers from similar flaws. (*See* SEC Br. at 20-21.)

different and more exacting than the elements of aiding and abetting liability. Indeed, in each of the SEC's hypothetical scenarios, the SEC fails to show how the business counterparty's conduct was relied on by the hypothetical investors, or how the business counterparty's conduct was in connection with the purchase or sale of a security.

Finally, the Regents seemingly contend that although the Business Defendants did not make, or play any role in preparing, the allegedly false statements on which Homestore investors relied, they can be liable under Section 10(b) and Rule 10b-5(b) because they allegedly "generated" the false revenues that were "ultimately communicated to the market by" Homestore. (Regents Br. at 18-19.) However, because the revenues are not (and cannot be) "false" until they are inaccurately represented to the market through erroneous accounting and financial reporting by the issuer, and because the "generation" of revenues in a commercial transaction between a corporate entity and an issuer standing alone has no nexus to subsequent transactions by investors in the issuer's securities, this theory exhibits the same flaws as those previously discussed.

CONCLUSION

For the foregoing reasons, the judgment of the District Court below should be affirmed.

Dated: December 21, 2004
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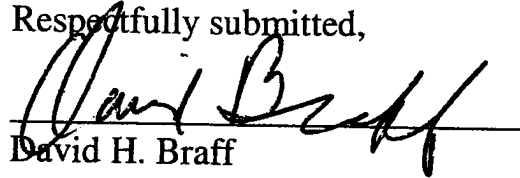
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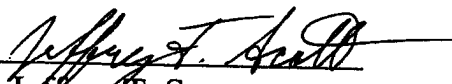

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**CERTIFICATE OF COMPLIANCE WITH
TYPEFACE AND LENGTH LIMITATIONS**

I, Jeffrey T. Scott, hereby certify that the foregoing Brief of The Bond Market Association, the Chamber of Commerce of the United States, the Clearing House Association L.L.C. and the Securities Industry Association, as *Amici Curiae*, in Support of Defendants-Appellees and Affirmance complies with the type-volume limitations of Federal Rule of Appellate Procedure 32 by using 14-point Times New Roman font, a proportionally spaced, serif typeface. According to the word count of the word processing program that was used to prepare it, this brief contains 6,999 words, exclusive of the Corporate Disclosure Statement, Table of Contents, Table of Authorities, and Certificates of Compliance and Service.

Dated: New York, New York
December 21, 2004


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CERTIFICATE OF SERVICE

I, Jeffrey T. Scott, hereby certify that on this 21st day of December, 2004, I caused an original and fifteen copies of the foregoing Brief of The Bond Market Association, the Chamber of Commerce of the United States, the Clearing House Association L.L.C. and the Securities Industry Association, as *Amici Curiae*, in Support of Defendants-Appellees and Affirmance (the "Brief") to be sent by Federal Express for delivery on December 22, 2004 to:

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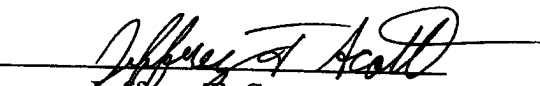
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