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# Making a Solid Connection: A New Look at Rule 10B-5's Transactional Nexus Requirement

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# MAKING A SOLID CONNECTION: A NEW LOOK AT RULE 10B-5'S TRANSACTIONAL NEXUS REQUIREMENT

Thomas J. Molony\*

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## INTRODUCTION

As the United States Supreme Court observed in *Marine Bank v. Weaver*, “Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.”<sup>1</sup> Accordingly, when it drafted section 10(b) of the Securities Exchange Act of 1934<sup>2</sup> (Exchange Act), a broad,

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1. *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

2. 15 U.S.C. §§ 78a–78pp (2006).

“catch-all” antifraud provision,<sup>3</sup> Congress provided that the statute applies only to a fraud that is “in connection with” a securities transaction.<sup>4</sup> The Securities and Exchange Commission (SEC) appropriately imposed the same limitation in Rule 10b-5,<sup>5</sup> the SEC’s “powerful antifraud weapon”<sup>6</sup> under section 10(b).

The “in connection with” requirement—sometimes referred to as the “transactional nexus” requirement<sup>7</sup>—is simple in concept, but difficult in application. Courts long have struggled to interpret its breadth. The Supreme Court has considered the issue in only three cases, all three of which dealt with the same type of fraud—that involving the misappropriation of assets.<sup>8</sup> In those cases, the Court employed a test that, according to Justice Thomas, reflects “an inconsistent and incoherent interpretation of the relevant statutory language and . . . does not provide any predictable guidance as to what behavior contravenes the statute.”<sup>9</sup> Indeed, the Court’s test is hard to apply even to misappropriation cases, and it is difficult to distill from it a fundamental principle appropriate to analyze the “in connection with” requirement more generally.

The Supreme Court in its few “in connection with” cases has stated that, to meet the requirement, a fraud must “touch” or “coincide” with a securities transaction.<sup>10</sup> These words, unfortunately, do little more than restate the

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3. *Chiarella v. United States*, 445 U.S. 222, 226 (1980).

4. 15 U.S.C. § 78j(b) (emphasis added).

5. 17 C.F.R. § 240.10b-5 (2011).

6. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 12.3[2], at 442 (6th ed. 2009).

7. *See, e.g., Ind. Elec. Workers Pension Trust Fund v. Millard*, No. 07 Civ. 172 (JGK), 2007 WL 2141697, at \*6 (S.D.N.Y. July 25, 2007) (“[F]raud is ‘in connection with’ a purchase or sale when there is a ‘transactional nexus’ between the fraud and the transaction.”).

8. *See generally S.E.C. v. Zandford* 535 U.S. 813, 820 (2002) (addressing a misappropriation of cash); *United States v. O’Hagan*, 521 U.S. 642, 656 (1997) (considering the “misappropriation theory” of insider trading); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 8 (1971) (addressing a misappropriation of cash).

9. *O’Hagan*, 521 U.S. at 692 (Thomas, J., dissenting).

10. *See Zandford*, 535 U.S. at 822 (“It is enough that the scheme to defraud and the sale of securities coincide.”); *O’Hagan*, 521 U.S. at 656 (“The securities transaction and the breach of duty thus coincide.”); *Bankers Life*, 404 U.S. at 12–13 (“The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor.”).

requirement under section 10(b) and Rule 10b-5 that a fraud be “in connection with” a securities transaction.<sup>11</sup> They say nothing of the degree of connection that is required.<sup>12</sup> The Court’s emphasis that section 10(b) should be interpreted “flexibly to effectuate its remedial purposes” only adds to the uncertainty.<sup>13</sup>

Attempting to provide some structure to the transactional nexus requirement under section 10(b) and Rule 10b-5, the United States Court of Appeals for the Fourth Circuit in 2009 devised a multifactor test that draws on cases from the Supreme Court and the United States Courts of Appeals for the Third and Tenth Circuits.<sup>14</sup> In *SEC v. Pirate Investor LLC*, the Fourth Circuit identified four relevant factors to be considered:

- (1) whether a securities sale was necessary to the completion of the fraudulent scheme;
- (2) whether the parties’ relationship was such that it would necessarily involve trading in securities;
- (3) whether the defendant intended to induce a securities transaction; and
- (4) whether material misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely.<sup>15</sup>

The court indicated that the factors “exist merely to guide the inquiry,” and stressed that they “are not mandatory

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11. See C. Edward Fletcher, III, *The “In Connection With” Requirement of Rule 10b-5*, 16 PEPP. L. REV. 913, 962 (1989) (emphasizing that the concept of “touching” was a product of Justice’s Douglas’s literary style and that he merely was stating in a different way that the fraud must be “in connection with” a securities transaction); see also *S.E.C. v. Pirate Investor LLC*, 580 F.3d 233, 244 (4th Cir. 2009) (“[T]o say that fraud is ‘in connection with’ a securities transaction whenever it ‘coincides’ with that transaction hardly clarifies the matter.”); *Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir. 1984) (“We are inclined to agree . . . that ‘there is no reason to believe that [Justice Douglas’s] use of ‘touching’ [in *Bankers Life*] was anything more than his variation of ‘in connection with’ as a matter of literary style.”).

12. Fletcher, *supra* note 11, at 962 (noting that “there is nothing in the notion of ‘touching’ that implies necessarily either a loose or a tight nexus requirement.”).

13. *Zandford*, 535 U.S. at 819 (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)); see *Bankers Life*, 404 U.S. at 12 (“Section 10(b) must be read flexibly, not technically and restrictively.”).

14. *Pirate Investor*, 580 F.3d at 244.

15. *Id.* (citations omitted) (internal quotation marks omitted).

requirements” and are not necessarily the only relevant factors.<sup>16</sup> Yet, the court provided no general principle for determining when a particular factor should apply, how to weigh the factors, or how to know when to consider other factors. Consequently, the test runs the risk of being—to quote Judge Posner—“like many other multi-factor tests, ‘redundant, incomplete, and unclear.’”<sup>17</sup>

This Article proposes to save *Pirate Investor*'s multifactor test from redundancy, incompleteness, and lack of clarity by introducing a general principle for the “in connection with” requirement and suggesting modifications to the Fourth Circuit's factors so that they inform application of the general principle. Part I provides an overview of Rule 10b-5 and the elements for civil enforcement actions, criminal prosecutions, and private causes of action under the Rule. Part II analyzes the Supreme Court's decisions with respect to the “in connection with” requirement and suggests that those decisions, together with Rule 10b-5's text, support an intent-based interpretation of the “in connection with” requirement. Part II also articulates a reasonable intent-based principle for the requirement. Part III explores *Pirate Investor* and the Third and Tenth Circuit cases on which *Pirate Investor* bases three of the four factors in its multifactor test. Part III asserts that the Supreme Court's misappropriation test—which is the first factor in the Fourth Circuit's test—should be limited to misappropriation cases and that the Fourth Circuit's factors should be modified in a manner consistent with the general principle described in Part II. Finally, the Article concludes that a fraud should be considered to be “in connection with” a securities transaction only when the perpetrator of the fraud intends to influence, or knows or is reckless in not knowing that his or her actions could influence, an investment decision. It also concludes that *Pirate Investor*'s multifactor test, when guided by and modified to serve this principle, provides a workable framework for determining when a fraud is “in connection

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16. *Id.* (“[W]e do not presume to exclude other factors that could help distinguish between fraud in the securities industry and common law fraud that happens to involve securities.”).

17. *Exacto Spring Corp. v. Comm'r of Internal Revenue*, 196 F.3d 833, 834 (7th Cir. 1999) (quoting *Palmer v. City of Chicago*, 806 F.2d 1316, 1318 (7th Cir. 1986)).

with” the purchase or sale of a security for purposes of Rule 10b-5.

### I. AN OVERVIEW OF RULE 10B-5

The SEC adopted Rule 10b-5 in 1942 pursuant to its authority under Exchange Act section 10(b).<sup>18</sup> The Rule provides:

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.<sup>19</sup>

Rule 10b-5 proscribes three different categories of fraud<sup>20</sup>: (i) misstatements,<sup>21</sup> (ii) misleading statements,<sup>22</sup> and (iii) pure omissions (i.e., silence) when there is a duty to disclose.<sup>23</sup> The Rule applies, however, only when a false or misleading statement or omission is material—that is, when

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18. 15 U.S.C. § 78j(b) (2006); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952).

19. 17 C.F.R. § 240.10b-5 (2011).

20. *See* STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 281 (3d ed. 2011) (identifying “omissions in breach of fiduciary duty,” “half-truths,” and “affirmative misstatements” as three categories of Rule 10b-5 fraud).

21. *See* 17 C.F.R. § 240.10b-5(b) (“It shall be unlawful for any person . . . [t]o make any untrue statement of a material fact.”).

22. *See id.* (“It shall be unlawful for any person . . . to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”)

23. *See id.* § 240.10b-5(a), (c); *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (indicating that liability for a failure to disclose material information only arises if there is a duty to disclose); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152–53 (1972) (noting that Rule 10b-5’s prohibition against fraud by omission when there is a duty to disclose is found in the first and third subparagraphs of the Rule).

there is a “substantial likelihood that the [statement or omission] . . . would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information available.”<sup>24</sup> Moreover, a Rule 10b-5 action is viable only if the defendant acted with scienter, which the Supreme Court in *Ernst & Ernst v. Hochfelder* defined as “a mental state embracing intent to deceive, manipulate, or defraud”<sup>25</sup> and which lower courts have expanded to include reckless behavior.<sup>26</sup>

The SEC, the U.S. Department of Justice, and private plaintiffs have recourse under Rule 10b-5.<sup>27</sup> Although the text of the Rule does not specify a private cause of action, courts have found that one is implied.<sup>28</sup> Standing for a private cause of action, however, is limited to purchasers and sellers of securities and does not extend to those who fail to purchase or sell securities because of fraudulent

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24. *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (internal quotation marks omitted).

25. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The Court stated expressly that it was not ruling on whether recklessness may constitute scienter. See *Hochfelder*, 425 U.S. at 193 n.12 (1976) (“We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.”). In *Aaron v. SEC*, the Supreme Court determined that scienter also is required for SEC enforcement actions. *Aaron v. S.E.C.*, 446 U.S. 680, 691 (1980); See *HAZEN*, *supra* note 6, § 12.8[1], at 457 (“The Supreme Court . . . held in *Aaron v. SEC* that the scienter standard applies under Rule 10b-5 regardless of whether the action is one for damages or an enforcement action brought by the Commission.”).

26. See, e.g., *S.E.C. v. Todd*, 642 F.3d 1207, 1215 (9th Cir. 2011) (“Reckless conduct may also constitute scienter.”); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008) (“[L]iability requires proof of the defendant’s ‘scienter,’ which is to say proof that he either knew the statement was false or was reckless in disregarding the substantial risk that it was false.”); *ATSI Commc’ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 n.3 (2d Cir. 2007) (“In a Rule 10b-5 action, scienter requires a showing of ‘intent to deceive, manipulate, or defraud,’ or reckless conduct.”) (citations omitted); *Robert N. Clemens Trust v. Morgan Stanley DW, Inc.*, 485 F.3d 840, 847 (6th Cir. 2007) (“[W]e have ‘long premised liability on at least reckless behavior.’”); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568 (9th Cir. 1990) (“Our circuit, . . . along with ten other circuits, has held that recklessness may satisfy the element of scienter in a civil action for damages under § 10(b) and Rule 10b-5.”).

27. See 15 U.S.C. § 78u (2006) (authorizing SEC actions to enforce rules under the Exchange Act); 15 U.S.C. § 78ff (2006) (providing for fines and imprisonment).

28. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730–31 (1975); see also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (“It is now established that a private right of action is implied under § 10(b).”).

misstatements or omissions.<sup>29</sup>

To be successful in a civil enforcement action, a criminal prosecution, or a private cause of action, the SEC, the Department of Justice, or the private plaintiff must prove that the defendant made a material misstatement or omission, that the defendant acted with scienter, and that the misstatement or omission was made “in connection with” a securities transaction.<sup>30</sup> A private plaintiff must go further and prove that the plaintiff reasonably relied on the misstatement or omission and that the misstatement or omission caused the plaintiff’s loss.<sup>31</sup>

Although reliance—or “transaction causation,” as it is sometimes called<sup>32</sup>—is an element of a private cause of action under Rule 10b-5, the Supreme Court in two respects has significantly curtailed the burden on plaintiffs to prove reliance. First, a plaintiff need not show reliance at all if the fraud is by means of a pure omission. In such a case, according to the Court in *Affiliated Ute Citizens of Utah v. United States*, “[a]ll that is necessary is that the facts withheld be material.”<sup>33</sup> Second, for securities traded in an efficient market, a plaintiff may qualify for a rebuttable presumption of reliance. In *Basic v. Levinson*, the Court validated a presumption of reliance employed by the Sixth

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29. See *Blue Chip Stamps*, 421 U.S. at 730–31 (noting that, in *Birnbaum v. Newport Steel Corp.*, the Court of Appeals for the Second Circuit determined that plaintiffs in a private cause of action under Rule 10b-5 were “limited to actual purchasers and sellers of securities” and holding that *Birnbaum* was decided correctly).

30. See *S.E.C. v. Pirate Investor LLC*, 580 F.3d 233, 239 (4th Cir. 2009) (listing the elements of a civil enforcement action); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 174 (3d Cir. 2000) (listing the elements of a private cause of action); *United Int’l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1220 (10th Cir. 2000) (same).

31. See *Semerenko*, 223 F.3d at 174 (listing the elements of a private cause of action); *Wharf*, 210 F.3d at 1220 (same); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008) (listing the elements of a private cause of action); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 338 (2005) (“A private plaintiff who claims securities fraud must prove that the defendant’s fraud caused an economic loss.”).

32. *Dura Pharm. Inc.*, 544 U.S. at 341; see HAZEN, *supra* note 6, § 12.11, at 479–80 (“The concept of transaction causation has been properly characterized as nothing more than ‘but for’ causation, and more questionably as merely another way of describing reliance. Although reliance and causation constitute distinct elements of a Rule 10b-5 claim, transaction causation may be established by facts that establish reliance.”) (internal quotations omitted).

33. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972).



Circuit when a plaintiff proves:

(1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.<sup>34</sup>

The Supreme Court has devoted considerable attention to the elements for a Rule 10b-5 action, particularly those necessary for a private cause of action. Its consideration of the “in connection with” requirement, however, has been meager at best. Yet, as the Third Circuit observed in *Semerenko v. Cendant Corp.*, “the ‘in connection with’ phrase is not the least difficult aspect of the 10b-5 complex to tie down.”<sup>35</sup>

## II. THE “IN CONNECTION WITH” REQUIREMENT

### A. Bankers Life, O’Hagan, and Zandford

The Supreme Court first addressed Rule 10b-5’s “in connection with” requirement in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, a case that involved a complex scheme under which the purchaser of a corporation’s stock misappropriated corporate assets to pay the purchase price of the stock.<sup>36</sup> Bankers Life & Casualty Company owned all of the stock of Manhattan Casualty Co., a casualty insurance company, and had agreed to sell the stock to James Begole.<sup>37</sup> Among Manhattan’s assets were U.S. Treasury bonds valued at approximately five million dollars, the purchase price under the agreement.<sup>38</sup> To complete the purchase of the Manhattan stock, Begole and others working with him orchestrated a series of transactions in which they caused Manhattan to sell the Treasury bonds for their full market value and misappropriated the proceeds to repay a short-term

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34. *Basic Inc. v. Levinson*, 485 U.S. 224, 248 n.27 (1988).

35. *Semerenko*, 223 F.3d at 174.

36. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971).

37. *Id.* at 7; see also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 430 F.2d 355, 357 (2d Cir. 1970).

38. *Bankers Life*, 404 U.S. at 8.

loan taken out to pay the purchase price for the Manhattan shares.<sup>39</sup> Meanwhile, they made it appear as if Manhattan had used the proceeds to purchase a certificate of deposit.<sup>40</sup>

The transactions rendered Manhattan insolvent, and the New York Department of Insurance eventually instituted liquidation proceedings.<sup>41</sup> In the course of liquidation, the Superintendent of Insurance, representing the interests of Manhattan, filed a lawsuit seeking damages under Rule 10b-5 with respect to the sale of Manhattan's Treasury bonds.<sup>42</sup> Specifically, the plaintiff claimed that Manhattan was defrauded when members of Manhattan's board of directors authorized the sale of the Treasury bonds based on false representations that the proceeds were to be used to purchase a certificate of deposit.<sup>43</sup>

The Supreme Court determined that Begole's scheme represented a fraud on Manhattan "in connection with" the sale of the Treasury bonds and, accordingly, that the plaintiff's claims met Rule 10b-5's "in connection with" requirement.<sup>44</sup> The Court reached this conclusion because Manhattan—the seller of the securities—was harmed by being deprived of the proceeds of the sale of the bonds through "deceptive practices *touching* its sale of securities."<sup>45</sup> Quoting *Shell v. Hensley*, the Court observed:

When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability.<sup>46</sup>

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39. *Id.*

40. *Id.* at 8–9.

41. Superintendent of Ins. v. Bankers Life & Cas. Co., 300 F. Supp. 1083, 1092 (S.D.N.Y. 1969); *Bankers Life*, 430 F.2d at 358.

42. *Bankers Life*, 404 U.S. at 7.

43. *Bankers Life*, 430 F.2d at 360.

44. *Bankers Life*, 404 U.S. at 9. Although the complaint alleged fraud in connection with the sale of the Manhattan stock, the Court's opinion only addressed whether the fraud was "in connection with" the sale of the Treasury bonds. *Id.* at 13 n.10.

45. *Id.* at 10, 12–13 (emphasis added).

46. *Id.* at 13 (quoting *Shell v. Hensley*, 430 F.2d 819, 827 (5th Cir. 1970)).

Sadly, the Court in *Bankers Life* did not offer a concrete test to apply broadly to Rule 10b-5's "in connection with" requirement.

The Supreme Court waited more than twenty-five years after *Bankers Life* before considering Rule 10b-5's transactional nexus requirement again. In *United States v. O'Hagan*, the Court considered whether trading in securities of a company based on information misappropriated from someone other than the company represents fraud "in connection with" a securities transaction in violation of the restrictions against insider trading under Rule 10b-5.<sup>47</sup> Dorsey & Whitney, a Minnesota law firm, represented Grand Metropolitan PLC (Grand Met) with respect to a possible tender offer for Pillsbury Company.<sup>48</sup> Before the tender offer became public, James O'Hagan, a partner of the firm who was not working on the transaction, purchased Pillsbury common stock and options.<sup>49</sup> When the tender offer was announced, the price of Pillsbury's stock rose considerably and O'Hagan sold his stock and options for a \$4.3 million profit.<sup>50</sup>

Whether O'Hagan violated Rule 10b-5 depended on whether O'Hagan's trading on the basis of his information about the tender offer was fraud and, if so, whether the fraud was "in connection with" his securities transactions. The Court easily found that O'Hagan had engaged in a fraud.<sup>51</sup> Noting that it had previously determined that "[t]he undisclosed misappropriation of . . . information, in violation of a fiduciary duty, . . . constitutes fraud,"<sup>52</sup> the Court concluded that O'Hagan committed a fraud on both his law firm and Grant Met because, as a partner of the firm, he owed a duty to them with respect to the information about the tender offer and violated that duty by taking the information and using the information for his own benefit.<sup>53</sup>

The "in connection with" requirement posed a more difficult question for the Court. The law firm and Grand Met were not parties to O'Hagan's securities transactions, and

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47. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

48. *Id.* at 647.

49. *Id.* at 647-48.

50. *Id.* at 648.

51. *Id.* at 653.

52. *Id.* at 654.

53. *See id.* at 653 (noting that O'Hagan's indictment charged him with breaching a duty of trust due his firm and its client).

O'Hagan did not deceive the other parties to the transactions because he did not owe them any duty to disclose the information he had.<sup>54</sup> Nevertheless, the Court found that O'Hagan's fraud was "in connection with" his purchase of the Pillsbury stock and options, reasoning that O'Hagan's misappropriation of the information about the Pillsbury tender offer "coincided" with his trading in the Pillsbury securities.<sup>55</sup> In adopting this "misappropriation theory" of insider trading, the Court observed that the "in connection with" requirement "is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principle, he uses the information to purchase or sell securities."<sup>56</sup>

The Court asserted that its adoption of the "misappropriation theory" was consistent with the purposes of the Exchange Act because the theory was necessary to protect the integrity of the securities markets.<sup>57</sup> According to the Court,

The theory is . . . well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. . . . Although informational disparity is inevitable in securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.<sup>58</sup>

The Court warned, however, that its misappropriation theory has limits and not all misappropriations that involve securities are subject to Rule 10b-5.<sup>59</sup> For example, according

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54. *Id.* at 653 n.5. The Court observed that, under the classical theory of insider trading, the insider's deception is perpetrated on the other party to the transaction. *Id.* at 653. The insider owes a duty of trust and confidence to the shareholders of his or her corporation, and when the insider trades in securities of the corporation based on material, nonpublic information without disclosing the information to the other party to the transaction, the insider breaches a duty to the other party to the transaction because the other party either is an existing shareholder (in the case of a purchase) or a future shareholder (in the case of a sale). *See id.* at 652 (noting that insiders owe a duty to the shareholders of the corporation and that trading without disclosing material, nonpublic information violates the duty and constitutes a deception).

55. *Id.* at 656.

56. *Id.*

57. *Id.* at 653.

58. *Id.* at 658.

59. *See id.* at 656.

to the Court, Rule 10b-5 would not apply when a person obtains money by fraud and then uses that money to purchase securities.<sup>60</sup> In such a case, the fraud is not sufficiently connected to the securities transaction because the money fraudulently obtained can be used for any number of purposes.<sup>61</sup> The Court noted that, in contrast, use of information of the type that O'Hagan obtained is more limited and typically is valuable only to the extent that it can be used to secure an advantage in a securities transaction.<sup>62</sup>

The Supreme Court in *O'Hagan* once again failed to express a general principle for Rule 10b-5's transactional nexus requirement. The Court did, however, provide a test for the requirement in the context of fraud accomplished through misappropriation. In a misappropriation case, the requirement is met—i.e., a fraud “coincides” with a securities transaction—when the securities transaction is necessary to complete the fraud.<sup>63</sup> This is so even if the person on the other side of the transaction is not the one defrauded.<sup>64</sup>

The Supreme Court returned to Rule 10b-5's transactional nexus requirement most recently in *SEC v. Zandford*, a case involving a broker's theft of proceeds of sales of his clients' securities.<sup>65</sup> Charles Zandford managed a discretionary securities account for William Wood and his daughter.<sup>66</sup> According to the SEC, without the Woods' authorization or disclosure to them, Zandford had written checks to himself that, for payment, required liquidation of securities in the Woods' account.<sup>67</sup> Consequently, the SEC asserted, Zandford had committed fraud “in connection with” a securities transaction in violation of Rule 10b-5.<sup>68</sup>

Taking the allegations in the SEC's complaint as true, the Court determined that the SEC had alleged conduct that

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60. *Id.* at 656.

61. *Id.* at 656–57.

62. *See id.* at 657 (noting that information of the type at issue in the case “ordinarily” is valuable because it can be used in trading securities).

63. *See id.* at 656 (“This element is satisfied because the fiduciary's fraud 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.”).

64. *Id.*

65. *S.E.C. v. Zandford*, 535 U.S. 813 (2002).

66. *Id.* at 815.

67. *Id.* at 821.

68. *Id.* at 816.

met the “in connection with” requirement.<sup>69</sup> According to the Court, Zandford’s alleged fraud consisted not of a misrepresentation to the Woods, but of Zandford’s failure to disclose to them his intention to execute sales of their securities and misappropriate the proceeds.<sup>70</sup> This fraud, the Court concluded, “coincided” with the securities transactions because

[t]he securities sales and [Zandford’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. Nor is it a case in which a thief simply invested the proceeds of a routine conversion in the stock market. Rather, [Zandford’s] fraud coincided with the sales themselves.<sup>71</sup>

The Court determined that, as a result, the SEC had met the pleading requirement for the “in connection with” requirement.<sup>72</sup>

The Supreme Court looked to *Bankers Life* to support its conclusions. It noted that, “[l]ike the company directors in *Bankers Life*, the Woods were injured as investors through [Zandford’s] deceptions, which deprived them of any compensation for the sale of their valuable securities.”<sup>73</sup> The Court drew on *Bankers Life* further, observing that a fraud need not affect the value of the securities involved or the “integrity of the securities markets” to meet the “in connection with” requirement.<sup>74</sup> Moreover, according to the Court, the fraud in *Zandford* posed a greater danger to the market than the one in *Bankers Trust* because a fraud of the type in *Zandford* “[n]ot only . . . prevent[s] investors from trusting that their brokers are executing transactions for their benefit, but [also] undermines the value of a discretionary account.”<sup>75</sup>

Without any analysis, the Court in *Zandford* refused to read *O’Hagan* to require, in the case of fraud through misappropriation, that the misappropriated assets “not have

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69. *Id.* at 825.

70. *Id.* at 820–21.

71. *Id.* at 820.

72. *See id.*

73. *See id.* at 822.

74. *Id.*

75. *Id.* 822–23.

independent value to the client outside the securities market.”<sup>76</sup> It observed, however, that even if *O’Hagan* imposed such a requirement, the fraud at issue in *Zandford* met the requirement. According to the Court, “the Woods’ securities did not have value for [Zandford] apart from their use in a securities transaction and [therefore] the fraud was not complete before the sale of securities occurred.”<sup>77</sup>

The “touch” test under *Bankers Life* and the requirement under *O’Hagan* and *Zandford* that a fraud “coincide” with a securities transaction are so vague that they cannot serve as a meaningful general principle for applying Rule 10b-5’s “in connection with” requirement. The cases nevertheless are useful because they set out some of the boundaries for the transactional nexus requirement and establish a test for courts to apply in cases involving fraud accomplished through misappropriation.

*Bankers Life*, *O’Hagan*, and *Zandford* describe several parameters for Rule 10b-5’s transaction nexus. First, the Rule must be “construed ‘not technically and restrictively, but flexibly to effectuate its remedial purposes.’”<sup>78</sup> Second, while Rule 10b-5 is designed to “insure honest securities markets,”<sup>79</sup> its remedial purposes reach beyond that goal.<sup>80</sup> Therefore, Rule 10b-5’s “in connection with” requirement can be met even if a “transaction is not conducted through a securities exchange or an organized over-the-counter market.”<sup>81</sup> Third, the fraud need not relate to the price or value of a security.<sup>82</sup>

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76. *Id.* at 824.

77. *Id.* at 824–25. The court also indicated, however, that Rule 10b-5 does not require that misappropriated assets “not have [an] independent value.” *See id.* at 824.

78. *Id.* at 819 (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (quoting *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963))); *see* *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (“Section 10(b) must be read flexibly, not technically and restrictively.”).

79. *United States v. O’Hagan*, 521 U.S. 642, 658 (1997).

80. *See Bankers Life*, 404 U.S. at 12 (“[Section] 10(b) . . . is not ‘limited to preserving the integrity of the securities markets’, though that purpose is included.”) (internal quotation marks omitted); *Zandford*, 535 U.S. at 821–22 (noting that, although *Bankers Life* “recognized that the interest in ‘preserving the integrity of securities markets’ was one of the purposes animating [section 10(b), it] rejected the notion that § 10(b) is limited to serving that objective alone.” (citing *Bankers Life*, 404 U.S. at 12)).

81. *Bankers Life*, 404 U.S. at 10.

82. *See id.* at 12; *Zandford*, 535 U.S. at 822.

Fourth, a fraud can be “in connection with” the purchase or sale of securities even if the deception is not perpetrated on a party to the transaction.<sup>83</sup> Finally, whether a state law remedy is available is irrelevant to determining the scope of Rule 10b-5.<sup>84</sup>

Undoubtedly, as to misappropriation cases, Rule 10b-5 applies if a securities transaction is necessary to complete the fraud.<sup>85</sup> To help explain this necessity test, the Court gave examples of how it is limited. Specifically, it indicated that, if the transaction occurs prior to the time the fraudulent scheme commences, the “in connection with” requirement is not met.<sup>86</sup> Likewise, the Court stated, the scheme is not “in connection with” a securities transaction if the scheme is complete before the transaction occurs.<sup>87</sup>

It is unclear whether the Supreme Court intended its necessity test to apply outside the misappropriation context,<sup>88</sup> but statements by the Court in *Bankers Life* and *Zandford* could be read to support its extension. In *Bankers Life*, for instance, the Court described as “irrelevant . . . the fact that the proceeds of the sale that were due [to Manhattan] were misappropriated.”<sup>89</sup> Similarly, the Court in *Zandford* stated that “[t]he fact that [the defendant] misappropriated the

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83. See *O'Hagan*, 521 U.S. at 658 (indicating that section 10(b) “requires deception ‘in connection with the purchase or sale of a security,’ not deception of an identifiable purchaser or seller.”).

84. *Bankers Life*, 404 U.S. at 12.

85. See *O'Hagan*, 521 U.S. at 656 (noting that the “in connection with” requirement “is satisfied because the fiduciary’s fraud 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.”); *Zandford*, 535 U.S. at 820 (“The securities sales and respondent’s fraudulent practices were not independent events.”); *Zandford*, 535 U.S. at 825 (“[T]he fraud was not complete before the sale of securities occurred.”).

86. See *Zandford*, 535 U.S. at 820 (noting that the fraud and the securities transaction are independent events when, “after a lawful transaction has been consummated, a broker decided to steal the proceeds and did so.”).

87. See *O'Hagan*, 521 U.S. at 656 (“The Government notes [that] . . . ‘[t]he misappropriation theory would . . . not apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities.’”); *Zandford*, 535 U.S. at 820 (noting that the fraud and the securities transaction are independent when “a thief simply invest[s] the proceeds of a routine conversion in the stock market.”).

88. Regardless of what the Court may have intended, lower courts have applied the necessity test in cases not involving misappropriation. See *infra* notes 139–40, 159 and accompanying text.

89. *Bankers Life*, 404 U.S. at 10.



proceeds of the sales provides persuasive evidence that he had violated section 10(b) when he made the sales, but misappropriation is not an essential element of the offense.”<sup>90</sup>

One might interpret the Court’s statements to suggest that its necessity test applies even if a fraud does not involve misappropriation. A better reading, however, is a more general one—whether a fraud is “in connection with” a securities transaction does not turn on whether misappropriation is involved. The misappropriation of proceeds from securities transactions, of course, was not irrelevant to the Court in *Bankers Life*. Without the misappropriation, there would have been no fraud. What *Bankers Life* meant by irrelevance, then, was that the mere fact that the fraud was a misappropriation of *cash* did not mean that there was no connection to a securities transaction. *Zandford* confirms this fact and offers a corollary, explaining that misappropriation is not required for a transaction to meet the “in connection with” requirement—that there are other ways for fraud and securities transactions to “coincide.”

### *B. Uncovering Support for an Intent-Based Principle*

Even though the misappropriation test does not represent a clear, general principle for determining whether a fraud is “in connection with” a securities transaction for Rule 10b-5 purposes, a general principle underlies the Supreme Court’s decisions in *O’Hagan* and *Zandford*. When examined closely, the decisions suggest that the intent of the alleged perpetrator of the fraud is critical to determining whether the requisite connection exists.

In *O’Hagan*, the Justice Department tried to distinguish *O’Hagan*’s trading based on misappropriated information regarding Grand Met’s tender offer for Pillsbury, which it claimed satisfied Rule 10b-5’s transactional nexus requirement, from the use of misappropriated cash to purchase securities, which it acknowledged did not.<sup>91</sup> Specifically, the government argued that the difference between the two scenarios is that “confidential information of the kind at issue [in *O’Hagan*] derives its value *only* from its utility in securities trading,” while “money can be used for all

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90. *Zandford*, 535 U.S. at 822.

91. *O’Hagan*, 521 U.S. at 656–57.

manner of purposes and purchases.”<sup>92</sup> Consequently, a securities transaction is necessary to complete a fraud with respect to the misappropriated information, but not with respect to misappropriated cash.<sup>93</sup>

Justice Thomas charged the government with exaggeration as to the information’s purported limited use. He observed that:

O’Hagan could have done any number of things with the information: He could have sold it to a newspaper for publication, he could have given or sold the information to Pillsbury itself, or he could even have kept the information and used it solely for his personal amusement, perhaps in a fantasy stock trading game. . . . That O’Hagan actually did use the information to purchase securities is thus no more significant here than it is in the case of embezzling money used to purchase securities.<sup>94</sup>

According to Justice Thomas, the government’s argument failed its own test because a securities transaction was not *necessary* to complete a misappropriation of the information.<sup>95</sup> Just as in the case of embezzling money, the fraud was complete when the information was taken.

The majority in *O’Hagan* considered the government’s exaggeration inapposite because the information that O’Hagan misappropriated “ordinarily” is valuable in trading securities.<sup>96</sup> According to the Court,

The misappropriation theory targets information of a sort that misappropriators *ordinarily* capitalize upon to gain no-risk profits through the purchase or sale of securities. Should a misappropriator put such information to other use, the statute’s prohibition would not be implicated. The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches

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92. *Id.* at 657.

93. *Id.* at 656 (noting the government’s claim that, in the case of embezzlement of funds and subsequent use to purchase securities, “the fraud would be complete as soon as the money was obtained.”) (internal quotation marks omitted).

94. *Id.* at 685–86 (Thomas, J., dissenting).

95. *Id.* at 686 (Thomas, J., dissenting) (“Under *any* theory of liability, however, these activities would not violate § 10(b) and, according to the Commission’s monetary embezzlement analogy, these possibilities are sufficient to preclude a violation under the misappropriation theory even where the informational property *was* used for securities trading.”).

96. *Id.* at 657–58.

fraudulent means of capitalizing on such information through securities transactions.<sup>97</sup>

The majority's conclusion therefore rests, not on the fact that the only fraud O'Hagan could have accomplished with the information was through a securities transaction, but on the fact that O'Hagan's actual fraud was completed through a securities transaction. The focus of the "in connection with" inquiry, then, is on whether a securities transaction was necessary to complete not just any fraud, but *the* fraud—the one the defendant perpetrated.

Of course, the fact that the actual use of the information is critical to determining whether the "in connection with" requirement is met does not necessarily mean that the defendant's intent is critical. Following *O'Hagan*, one is left to wonder whether the "in connection with" requirement is met if a fiduciary deceptively takes confidential information for a purpose other than trading, uses it for that other purpose, and later decides to trade based on the information. Under the Court's analysis, it seems that the fiduciary would have completed her misappropriation when she used the information for her non-trading purpose. Would the Court then also find that completion of her initially-contemplated misappropriation is sufficient to break the transactional nexus even though she ultimately engaged in a securities transaction based on the information?

Early in its opinion, the Court in *O'Hagan* suggested that the purpose of the misappropriation—what the defendant intends to do with the information—is significant.<sup>98</sup> Specifically, the Court stated that "[t]he 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates section 10(b) and Rule 10b-5, when he misappropriates confidential information *for securities trading purposes*, in breach of a duty owed to the source of the information."<sup>99</sup> Later, however, the Court seems to indicate that the actual use of

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97. *Id.* at 656 (emphasis added).

98. *Id.* at 652.

99. *Id.* (emphasis added); *see also O'Hagan*, 521 U.S. at 681 (Thomas, J., dissenting) ("The majority states, for example, that the misappropriation theory applies to undisclosed misappropriation of confidential information 'for securities trading purposes,' thus seeming to require a *particular intent* by the misappropriator in order to satisfy the 'in connection with' language.") (emphasis added).

the information, and not the person's intent, is the significant element for the "in connection with" requirement. According to the Court, the requirement "is satisfied because the fiduciary's fraud 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. The securities transaction and the breach of duty thus coincide."<sup>100</sup> The Court's opinion, therefore, is ambiguous as to whether the intent of the perpetrator of the fraud is critical to the "in connection with" requirement.

*Zandford*, however, confirms that intent indeed is the critical element. In *Zandford*, the Court highlighted the importance of the timing of Zandford's decision to misappropriate funds from the Woods and what he knew would be necessary to do so. According to the Court,

[t]he securities sales and [Zandford'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. Nor is it a case in which a thief simply invested the proceeds of a routine conversion in the stock market. Rather, [Zandford's] fraud coincided with the sales themselves. . . . With regard to the sales of shares in the Woods' mutual fund, [Zandford] initiated these transactions by writing a check to himself from that account, *knowing* that redeeming the check would require the sale of securities."<sup>101</sup>

For the Court in *Zandford*, then, it was important that the defendant knew that a securities transaction was required to achieve his desired outcome. It was important that the securities transaction was an intended part of the fraud.

Thus, following *Zandford*, it appears that, to determine whether the "in connection with" requirement is met with respect to a misappropriation, one must define the defendant's fraud by looking to the defendant's state of mind. To illustrate this point, consider the following four scenarios:

*Scenario One:* Without her client's knowledge or authorization, a broker sells \$1000 of her client's securities,

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100. *Id.* at 656.

101. *S.E.C. v. Zandford*, 535 U.S. 813, 820–21 (2002) (emphasis added).

intending to steal the proceeds. After the sale, the broker steals the \$1000 sale proceeds.

*Scenario Two:* With her client's authorization, a broker sells \$1000 of her client's securities. After the sale, the broker decides to steal the \$1000 sale proceeds and, without her client's knowledge, does so.

*Scenario Three:* Without Company A's knowledge or authorization, an officer of Company A takes confidential information from Company A, intending to use it to trade in the securities of Company B. After the officer takes the information, the officer trades in securities of Company B, reaping profits of \$1000.

*Scenario Four:* Without Company A's knowledge or authorization, an officer of Company A takes confidential information from Company A for the purpose of competing with Company A. After using the information to compete with Company A, the officer decides to trade in the securities of Company B based on Company A's information. The officer trades as planned, reaping profits of \$1000.

The substantive result in *Scenarios One* and *Two* is the same—the client's securities are sold and the broker wrongfully ends up with the \$1000 in sale proceeds. Under *Zandford*, however, only *Scenario One* satisfies the “in connection with” requirement.<sup>102</sup> In a broad sense, a securities transaction was necessary to complete both frauds. Without the securities transaction, no cash would have been available for the broker to take. The difference between the two scenarios, however—and the reason why *Scenario One* satisfies the requirement and *Scenario Two* does not—is one of intent. In both cases, the fraud began when the broker decided to take the sale proceeds and ended when the broker actually did so. The significant difference is that, in *Scenario One*, the transaction occurred while the broker had the intent

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102. *Scenario One* mimics *Zandford's* facts. *Scenario Two* represents a sequence of events that *Zandford* indicates would not satisfy the “in connection with” requirement. See *id.* at 820 (“This is not a case in which, after a lawful transaction had been consummated, a broker decided to steal the proceeds and did so.”).

to commit the fraud and, in *Scenario Two*, the transaction already had occurred when the broker formed her intent. In *Scenario One*, the broker's fraudulent intent and the securities transaction coincided, and the broker intended the securities transaction as part of the fraudulent scheme.

Like *Scenarios One* and *Two*, the substantive result in *Scenarios Three* and *Four* is the same—the officer takes Company A's confidential information and gains \$1000 in trading profits by trading in securities of Company B. *Scenario Three* undoubtedly satisfies the “in connection with” requirement under *O'Hagan*, and though the result for *Scenario Four* is unclear under *O'Hagan*, *Zandford* suggests that the requirement would not be met. Again, the difference is one of intent. In both scenarios, the fraud began when the officer took the information and ended when she used it for her intended purpose. In *Scenario Three*, her intended purpose was to trade, and the fraud was not complete until she traded. A securities transaction, therefore, was required to complete her fraud. In *Scenario Four*, in contrast, the officer's intended purpose was to compete, and the fraud was completed when she used the information to compete. Her securities transaction occurred after her fraud was complete, and therefore, the fraud was not “in connection with” the securities transaction for purposes of Rule 10b-5.

*O'Hagan* and *Zandford* are not the only sources of support for an intent-based interpretation of Rule 10b-5's transactional nexus requirement. Such an interpretation also finds support in the policy underpinnings of Exchange Act section 10(b) and Rule 10b-5. The two principal goals of section 10(b) and Rule 10b-5 are deterring securities fraud and compensating the victims of securities fraud.<sup>103</sup> The text of the statute and the Rule suggests that the “in connection with” requirement primarily is meant to serve the deterrence goal. In their essence, section 10(b) and Rule 10b-5 represent a means for civil antifraud enforcement by the SEC and criminal antifraud enforcement by the Department of Justice.<sup>104</sup> This is evident from the fact that both the statute

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103. See Donald Langevoort, *Reflections on Scierter (and the Securities Fraud Case Against Martha Stewart that Never Happened)*, 10 LEWIS & CLARK L. REV. 1, 9 (2006) (identifying “deterrence [and] compensatory effect” as policy considerations).

104. See HAZEN, *supra* note 6, § 16.2[8], at 653 (“SEC investigations that

and the Rule describe the proscribed conduct as “unlawful”<sup>105</sup> and make no mention of a private cause of action.<sup>106</sup> Because the statute and the Rule are written in this way, it is logical to read the elements that the SEC or the Department of Justice must prove as serving one the goals of punishment, which deterrence is, but compensation is not.<sup>107</sup> Compensation, of course, ordinarily is achieved through a private cause of action under the Rule. Consequently, the elements unique to a private cause of action—reliance and causation—should be interpreted in light of that goal.<sup>108</sup>

The transactional nexus requirement is an element required for civil and criminal enforcement of Rule 10b-5<sup>109</sup> and therefore should be read in a way that primarily serves the goal of deterrence. An intent-based general principle for the requirement does just that. A person will not be deterred from fraudulently influencing an investment decision<sup>110</sup> if she

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reveal wrongdoing may result in SEC injunction actions brought in federal district court. Alternatively, the SEC can refer the case to the Department of Justice to determine if criminal sanctions are appropriate.”); 15 U.S.C. § 78u(d)(1) (2006) (authorizing the SEC to seek injunctive relief and to provide evidence to the Attorney General for criminal proceedings regarding violations of the Exchange Act); *id.* § 78u(d)(3) (2006) (authorizing the SEC to seek civil penalties for violations of the Exchange Act); *id.* § 78ff(a) (2006) (providing for fines and imprisonment for violations of the Exchange Act).

105. See 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5 (2012).

106. Neither the history of the statute nor the Rule suggests that Congress or the SEC contemplated a private cause of action. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729–30 (1975) (“Nor does the history of [section 10(b)] provide any indication that Congress considered the problem of private suits under it at the time of passage. Similarly there is no indication that the Commission in adopting Rule 10b-5 considered the question of private civil remedies under this provision.”); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976). (“[Section] 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when it adopted Rule 10b-5, contemplated such a remedy . . .”).

107. See Mary Kreiner Ramirez, *Criminal Affirmance: Going Beyond the Deterrence Paradigm to Examine the Social Meaning of Declining Prosecution of Elite Crime*, 45 CONN. L. REV. 865, 907–08 (noting that theories of punishment include retribution, incapacitation, rehabilitation, specific deterrence, and general deterrence).

108. See *supra* note 31 and accompanying text (noting the additional elements that a private plaintiff must prove under Rule 10b-5).

109. See *supra* note 30 and accompanying text (noting that the SEC and the Department of Justice, as well as private plaintiffs, must meet the “in connection with” requirement to be successful in enforcing Rule 10b-5).

110. Because a purchase or sale is not required for an SEC civil enforcement action or for a criminal prosecution, see *infra* note 133 and accompanying text, the object of the fraud must be broader than a securities transaction. One of the

should not reasonably know her actions might have that influence. Extending the “in connection with” requirement beyond a culpable statement of mind, therefore, extends it too far—to a point where it no longer serves as a deterrent.

Although *O’Hagan* and *Zandford*, together with the text of Rule 10b-5, suggest an intent-based general principle for interpreting Rule 10b-5’s transactional nexus requirement, other courts have used causation as a general principle. For example, the Third Circuit in *Semerenko v. Cendant Corp.*, a case from which the Fourth Circuit in *Pirate Investor* draws one of its factors, claimed that “the ‘in connection with’ language requires a causal connection between the claimed fraud and the purchase or sale of a security.”<sup>111</sup> A causation-based general principle, however, is inconsistent with Rule 10b-5’s essence as a tool for civil enforcement by the SEC and criminal enforcement by the Department of Justice. Moreover, it is inappropriate in light of the elements of Rule 10b-5’s implied private cause of action.

As indicated in Part II, the “in connection with” requirement is an element both of the prima facie case for civil or criminal enforcement of Rule 10b-5 and for a private cause of action thereunder. Causation, on the other hand, only is an element of a private cause of action. If the “in connection with” requirement simply contemplates a causal connection, the causation element for a private cause of action is redundant—at least to a degree.

There are two different types of causation that a private plaintiff must prove—reliance (or transaction causation) and loss causation. The redundancy created by interpreting the transactional nexus to require causation largely relates to reliance<sup>112</sup> and becomes apparent when one compares the

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early cases involving the “in connection with” requirement looked to the investing public as the relevant object. *See* *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (“Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public . . .”).

111. *Semerenko v. Cendant Corp.*, 223 F.3d 165, 175 (3d Cir. 2000). The Seventh Circuit appears to take a similar approach. *See* *S.E.C. v. Jakubowski*, 150 F.3d 675, 680 (7th Cir. 1998) (“Many of this court’s cases say that a misrepresentation can be ‘in connection with’ the purchase or sale of securities only if it influences an investment decision.”).

112. *Angelaastro*, however, suggests a causation requirement that overlaps with the loss causation element of a private cause of action under Rule 10b-5.



elements under *Semerenko* for finding a causal connection sufficient to establish a transactional nexus to the elements under *Basic* for a plaintiff to qualify for a presumption of reliance. According to the Third Circuit in *Semerenko*,

Th[e] purpose [of Exchange Act § 10(b) and Rule 10b-5] is best satisfied by a rule that recognizes the realistic causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities. We therefore . . . hold that the Class may establish the 'in connection with' element simply by showing that the misrepresentations in question were *disseminated to the public* in a medium upon which a reasonable investor would rely, and that they were *material* when disseminated.<sup>113</sup>

The Supreme Court in *Basic* similarly stated that, “[i]ndeed, nearly every court that has considered the proposition has concluded that where *materially* misleading statements have been *disseminated into an impersonal, well-developed market for securities*, the reliance of individual plaintiffs on the integrity of the market price may be presumed.”<sup>114</sup> Thus, the components of *Semerenko*'s transactional nexus test and *Basic*'s requirement for a rebuttable presumption of reliance are so similar that, in most cases, if a fraud meets *Semerenko*'s “in connection with” test, the plaintiff also will qualify for *Basic*'s presumption of reliance. Because a transactional nexus and reliance are separate and distinct elements under Rule 10b-5,<sup>115</sup> such an overlap indicates that

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*Compare* Angelastro v. Prudential-Bache Sec. Inc., 764 F.2d 939, 944 (3d Cir. 1985) (“As noted, this Court has construed the ‘in connection with’ language as requiring some causal connection between the alleged misrepresentation and the harm incurred when a security is purchased or sold.”) with *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005) (noting that a private cause of action under Rule 10b-5 requires a plaintiff to prove “*loss causation*,’ i.e., a causal connection between the material misrepresentation and the loss”) (citing 15 U.S.C. § 78u-4(b)(4)).

113. *Semerenko*, 223 F.3d at 176 (emphasis added).

114. *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988) (emphasis added).

115. *See* S.E.C. v. Rana Research, Inc., 8 F.3d 1358, 1361 (9th Cir. 1993) (“Defendants’ argument treats the concepts of ‘reliance’ and ‘in connection with’ as interchangeable, but they are distinct.”). The transactional nexus requirement and reliance must be separate elements because a transactional nexus is required for a civil enforcement or criminal action, but reliance is not. *See supra* notes 30–31 (distinguishing civil enforcement and criminal actions from private causes of action).

a causation-based principle for the “in connection with” requirement is unsuitable.<sup>116</sup>

In addition, a causation-based principle inappropriately focuses the transactional nexus inquiry on the plaintiff. As the United States Court of Appeals for the Fifth Circuit observed in *Roland v. Green*:

Viewing the allegations from the plaintiffs’ perspective . . . asks the wrong question. By tying the ‘coincide’ requirement to ‘inducement,’ it unnecessarily imports causation into a test whose language (‘coincide’) specifically disclaims it. [A] defendant-oriented perspective . . . is more faithful to the Court’s statement [in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*] that ‘[t]he requisite showing . . . is deception in connection with the purchase or sale of any security,’ *not deception of an identifiable purchaser or seller*.<sup>117</sup>

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116. One might argue that *Semerenco’s* transactional nexus principle is distinct from the reliance element of a private cause of action under Rule 10b-5 because satisfaction of *Semerenco’s* principle results only in a *presumption* of reliance and does not actually *satisfy* the reliance element. See *Semerenco*, 223 F.3d at 179 (“The fraud on the market theory of reliance, however, creates only a presumption, which the defendant may rebut by raising any defense to actual reliance.”). Such an argument, however, ignores how *Basic’s* presumption may be rebutted and the practical realities of litigating a large swath of Rule 10b-5 cases—class actions with respect to securities traded in an efficient market. *Basic* indicates that the presumption of reliance may be rebutted by “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price . . . .” *Basic*, 485 U.S. at 248. If a class action defendant can sever the link by showing that the misrepresentation did not affect the price, then the misrepresentation very likely is not material and the plaintiff could not satisfy *Semerenco’s* causal connection test or qualify for *Basic’s* presumption because materiality is an element of each. See STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION ESSENTIALS 134 (2008) (indicating that the lack of effect of a misrepresentation on the price of a security indicates that the misrepresentation is not material); see also *In re Merck & Co., Inc. Sec. Litig.*, 432 F.3d 261, 274 (3d Cir. 2005) (“If a company’s stock trades on an efficient market, . . . ‘the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm’s stock.’”). If a defendant in a class action cannot sever the link between the misrepresentation and the price, the defendant is left with trying to sever the link between the misrepresentation and the decision to trade, which “is not feasible to [do] for every member of the class.” CHOI & PRITCHARD, *supra*, at 135. Consequently, in a large class action with respect to a security traded on a national securities exchange, by qualifying for a rebuttable presumption of reliance, the plaintiffs, for all practical purposes, have established the reliance element.

117. *Roland v. Green*, 675 F.3d 503, 519 (5th Cir. 2012) (quoting *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85 (2006)); see also

An intent-based general principle appropriately focuses the inquiry on the defendant and therefore is consistent with how the Supreme Court has characterized the “in connection with” requirement. One might argue, however, that an intent-based interpretation would overlap with Rule 10b-5’s scienter requirement and therefore would suffer from the same problem a causation-based interpretation does vis-à-vis reliance. As Donald Langevoort points out, however, when determining scienter, “the relevant question is not motive or purpose but awareness—[whether] the defendant [knew] . . . that what she was saying was false.”<sup>118</sup> Moreover, Professor Langevoort suggests that, although the Second Circuit in *AUSA Life Insurance Co. v. Ernst & Young* described the scienter issue as one of foreseeability of the result, foreseeability “may not be the precise articulation” of the meaning of scienter because foreseeability has been the dominant standard for the “in connection with” requirement.<sup>119</sup> Instead, he asserts, scienter encompasses “[a]n appreciation of the falsity by the speaker.”<sup>120</sup> The element of scienter under Rule 10b-5, then, considers whether the defendant had the intent to deceive, defraud, or manipulate or knew or recklessly failed to appreciate that her action would have that effect;<sup>121</sup> it does not focus on the object of the intent, knowledge, or recklessness (e.g., whether an investment decision or something else).

*O’Hagan* and *Zandford* confirm that an intent-based interpretation of the transactional nexus requirement does not result in conflating the requirement with scienter. Under

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United States v. O’Hagan, 521 U.S. 642, 658 (1997). (“The misappropriation theory comports with § 10(b)’s language, which requires deception ‘in connection with the purchase or sale of any security,’ not deception of an identifiable purchaser or seller.”).

118. See Langevoort, *supra* note 103, at 6. Professor Langevoort notes that the district court in *U.S. v. Stewart* “misunderstood the law” when it dismissed the criminal prosecution of Martha Stewart under Rule 10b-5 because the court had concluded that “a reasonable jury could not find beyond a reasonable doubt that Stewart intended to deceive investors.” *Id.* at 5.

119. *Id.* at 6. See *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 221 (2d Cir. 2000) (noting that the district court focused on the defendant’s motive and that such a focus “inappropriately makes the scienter issue one of ‘what did the defendant want to happen’ as opposed to ‘what could the defendant reasonably foresee as a potential result of his action.’”).

120. Langevoort, *supra* note 103, at 6.

121. See *supra* notes 25–26 and accompanying text (describing how courts have interpreted the meaning of “scienter”).

*O'Hagan's* misappropriation theory, "a person commits fraud 'in connection with' a securities transaction, and thereby violates section 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."<sup>122</sup> Therefore, under *O'Hagan*, a person violates Rule 10b-5 when he or she has both an intent to deceive and an intent to trade. If a person discloses to the source of the information his or her intent to trade, Rule 10b-5 is not violated because the person does not have the intent to deceive, and does not deceive, the source.<sup>123</sup> The person's intent to trade, however, persists. Moreover, *Zandford* indicates that "if [a] broker told his client he was stealing the client's assets, that breach of fiduciary duty might be in connection with a sale of securities, but it would not involve a deceptive device or fraud."<sup>124</sup> Again, there would be no intent to deceive or actual deception, but the defendant's intent to trade would remain.

Thus, based on *O'Hagan* and *Zandford*, a defendant's state of mind is significant with respect to two separate elements. The defendant's intent to deceive is important to scienter, and the defendant's intent to engage in a securities transaction or to take an action that the defendant knows will require a securities transaction is critical to the "in connection with" requirement.

### C. A Workable Intent-Based Principle

Determining that satisfaction of Rule 10b-5's "in connection with" requirement should be measured based on the intent of the perpetrator of the fraud is only a starting point. For courts to apply the Rule's transactional nexus requirement in a meaningful and consistent manner, they must have more than just a vague notion of what the requirement means. To craft a workable general principle based on intent, two components should be considered: first, what constitutes intent and, second, what the object of the

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122. *O'Hagan*, 521 U.S. at 652.

123. *Id.* at 655 ("Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation . . .").

124. *S.E.C. v. Zandford*, 535 U.S. 813, 825 n.4 (2002).

intent is. As discussed below, case law supports a scienter-like definition of intent, and influencing an investment decision as the object of that intent.

In trying to articulate an intent-based principle for Rule 10b-5's "in connection with" requirement, the logical place to look is Rule 10b-5's other element to which state of mind is relevant—scienter. *O'Hagan's* adoption of the misappropriation theory for insider trading indicates that Rule 10b-5 can apply even in the unusual case when a defendant's intent is divided—when the defendant intends to deceive one person and intends to engage in a securities transaction with another.<sup>125</sup> In most cases, however, a defendant's intent will not be divided. Typically, the person the defendant intends to deceive will be the very same person the defendant intends to influence with respect to a securities transaction. In light of this fact, it is reasonable to interpret the scope of the "in connection with" requirement in a manner consistent with the scope of the scienter requirement. Indeed, although Professor Langevoort notes that the meaning of scienter is distinct from the "in connection with" requirement, he approvingly states that, by using for scienter a standard commonly associated with the "in connection with" requirement, the Second Circuit in *AUSA* had "conjoin[ed] the scienter and 'in connection with' tests in a way that makes holistic sense in defining what constitutes securities fraud."<sup>126</sup>

In *Hochfelder*, the Supreme Court's landmark case establishing scienter as a required element for a private cause of action under Rule 10b-5,<sup>127</sup> the Court stated that "[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe *knowing* or *intentional* misconduct."<sup>128</sup> As a result, knowledge and specific intent should be

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125. See *O'Hagan*, 521 U.S. at 656 ("A misappropriator who trades on the basis of material, nonpublic information . . . deceives the source of the information and simultaneously harms members of the investing public.").

126. See Langevoort, *supra* note 103, at 6.

127. In *Aaron v. SEC*, the Supreme Court determined that scienter also is required for SEC enforcement actions. *Aaron v. S.E.C.*, 446 U.S. 680, 691 (1980); see HAZEN, *supra* note 6, § 12.8[1], at 457 ("The Supreme Court . . . held in *Aaron v. SEC* that the scienter standard applies under Rule 10b-5 regardless of whether the action is one for damages or an enforcement action brought by the Commission.").

128. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (emphasis added).

components of the defendant's state of mind for purposes of the "in connection with" requirement. This conclusion is consistent with the facts of the Supreme Court's three "in connection with" cases. In *Bankers Life*, the defendants *intended* to influence the decision of Manhattan's board of directors to authorize the sale of Manhattan's Treasury bonds.<sup>129</sup> Likewise, the defendant in *O'Hagan* *intended* to engage in securities transactions based on the confidential information he misappropriated.<sup>130</sup> Finally, in *Zandford*, the defendant wrote checks on his clients' account, *knowing* that a securities transaction would be required to fund the checks.<sup>131</sup>

Whether the state of mind applicable to the transactional nexus requirement should extend to recklessness is unclear from the Court's "in connection with" cases, but the Courts of Appeals generally have recognized recklessness as a component of scienter.<sup>132</sup> In addition, the Third Circuit in *Semerenko* and *In re Ames Department Stores Inc. Stock Litigation* addressed recklessness in its consideration of the "in connection with" requirement. In *Semerenko*, the court stated that "under the standard which we adopt [for the transactional nexus requirement], the [plaintiffs are] not required to establish that the defendants actually envisioned that [the plaintiffs] would rely upon the alleged misrepresentations when making their investment decisions. Rather, [they] must only show that the alleged misrepresentations were reckless."<sup>133</sup> Similarly, in rejecting

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129. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 7–9 (1971) (describing a deliberate scheme to mislead the directors).

130. See *O'Hagan*, 521 U.S. at 656 (noting that information of the type that O'Hagan misappropriated "ordinarily" is useful only for reaping trading profits).

131. See *S.E.C. v. Zandford*, 535 U.S. 813, 821 (2002) ("With regard to the sales of shares in the Woods' mutual fund, respondent initiated these transactions by writing a check to himself from that account, knowing that redeeming the check would require the sale of securities.").

132. See *Findwhat Investor Grp. v. Findwhat.com*, 658 F.3d 1282, 1299 (11th Cir. 2011) ("In this Circuit, 'scienter consists of intent to defraud or severe recklessness on the part of the defendant.'"); *Mississippi Pub. Emps.' Ret. Sys. v. Boston Scientific Corp.*, 649 F.3d 5, 20 (1st Cir. 2011) ("Under this circuit's precedent, proving scienter requires 'a showing of either conscious intent to defraud or a high degree of recklessness.'"); *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 507 (9th Cir. 1992) ("Scienter may be satisfied by either proof of actual knowledge or recklessness."); see also *supra* note 26 (citing cases recognizing that recklessness is a component of scienter).

133. *Semerenko v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000).

the defendants' argument that they must have envisioned the impact of their statements on investors for the statements to have the requisite connection, the court in *Ames* stated that the defendants had disregarded "the well-established rule that reckless, as well as intentional, manipulation of the stock market may violate Rule 10b-5."<sup>134</sup> Thus, it seems appropriate to include recklessness as a component state of mind for purposes of the "in connection with" requirement.<sup>135</sup>

For purposes of the "in connection with" requirement, the object of the defendant's intent must be broader than a purchase or sale. This is so because Rule 10b-5's purchase or sale requirement only applies to standing with respect to a private cause of action.<sup>136</sup> Neither a purchase nor a sale is required for civil enforcement by the SEC or criminal prosecution by the Department of Justice.<sup>137</sup> Bearing this in

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134. *In re Ames Dep't Stores Inc. Stock Litig.* 991 F.2d 953, 965 (2d Cir. 1993) *Semerenko* and *Ames* are interesting because, in one breath, they purport to establish a causation-based standard for the "in connection with" requirement and, in another, they discuss intent and the fact that reckless conduct can violate Rule 10b-5. See *Semerenko*, 223 F.3d at 176 (noting that a causal connection serves the purposes of Rule 10b-5 and then discussing recklessness); *Ames*, 991 F.2d at 965-66 (discussing recklessness and then noting that "statements which manipulate the market price are connected to resultant stock trading"). It is unclear, however, whether these cases are merely referring to the Rule's scienter requirement or are incorporating an intent element into their "in connection with" tests. Although *Semerenko* cites *In re Advanta Corp. Sec. Litig.*'s discussion of scienter, the court seems to suggest that recklessness need only be shown "under the standard which we adopt" for the "in connection with" requirement. See *Semerenko*, 223 F.3d at 176 (citing *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999)). *Ames* mentions scienter specifically, perhaps indicating only that its "in connection with" rule should be considered with the separate scienter element in mind. See *Ames*, 991 F.2d at 965 n.6.

135. Although reckless conduct may satisfy both elements, what constitutes recklessness may be different under each. For example, Professor Langevoort suggests that "[a]n appreciation of the falsity by the speaker is all that is necessary" for scienter, while foreseeability is the prevailing standard used by courts for the "in connection with" requirement. Langevoort, *supra* note 103, at 6.

136. See *supra* note 29 and accompanying text (noting that a private cause of action requires a purchase or sale).

137. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 751 n.14 (1975) ("[T]he purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under § 10(b) and Rule 10b-5."); *United States v. O'Hagan*, 521 U.S. 642, 664 (1997). ("Criminal prosecutions do not present the dangers the Court addressed in *Blue Chip Stamps*, so that decision is 'inapplicable' to indictments for violations of § 10(b) and Rule 10b-5."); *S.E.C. v. Rana Research, Inc.*, 8 F.3d 1358, 1362 (9th Cir. 1993) ("While interpretations of 'in connection with' continue to change as applied to private plaintiffs, its

mind, in light of Rule 10b-5's definition of materiality,<sup>138</sup> which focuses on the importance of information to an investor's decision, and taking into account how a number of lower courts have interpreted the "in connection with" requirement,<sup>139</sup> an investment decision is the proper object of a defendant's intent for purposes of the Rule 10-5's transactional nexus requirement.

Based on the foregoing, then, one might articulate a suitable principle as follows: for purposes of Rule 10b-5, a fraud is "in connection with" a securities transaction only when the perpetrator of the fraud intends to influence, or knows or is reckless in not knowing that his or her actions could influence, an investment decision. Such a principle appropriately employs scienter-like intent and sets an investment decision as its object.<sup>140</sup>

### III. PIRATE INVESTOR'S MULTIFACTOR TEST

In *Pirate Investor*, the Fourth Circuit considered whether an e-mail stock tip containing misrepresentations violated

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meaning in SEC actions remains as broad and flexible as is necessary to accomplish the statute's purpose of protecting investors.") (citing *S.E.C. v. Hasho*, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992); *S.E.C. v. Benson*, 657 F. Supp. 1122, 1131 (S.D.N.Y. 1987); *S.E.C. v. Warner*, 652 F. Supp. 647, 651 (S.D. Fla. 1987); *S.E.C. v. Joseph Schlitz Brewing Co.*, 452 F. Supp. 824, 829 (E.D. Wis. 1978); *S.E.C. v. Gen. Refractories Co.*, 400 F. Supp. 1248, 1257 (D.D.C. 1975)).

138. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (adopting the materiality standard from *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976), which focuses on the importance of information to an investor's decision making).

139. See *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) ("[W]e hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public . . . ."); *United Int'l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1221 (10th Cir. 2000) ("[T]he misrepresentations were made to influence UIH's investment decision and were made in connection with the purchase or sale of a security."); *S.E.C. v. Jakubowski*, 150 F.3d 675, 680 (7th Cir. 1998) (noting that "only investment decisions come within Rule 10b-5.").

140. One might argue this principle is not broad enough to capture insider trading under the misappropriation theory in which the defendant does not seek to influence an investment decision by the person from whom she takes the information or the investment decision of the person on the other side of her trade. The Seventh Circuit in *SEC v. Jakubowski*, however, has suggested that influencing the investment decision of the perpetrator of the fraud is sufficient for the "in connection with" requirement. See *Jakubowski*, 150 F.3d at 680 ("Jakubowski . . . made [an] investment decision[] when [he] purchased the stock issued by the converting S&Ls.").



Rule 10b-5.<sup>141</sup> In May 2002, the editor-in-chief of Pirate Investor, LLC, a publisher of investment newsletters, sent multiple waves of e-mails containing a stock tip to over 800,000 individuals.<sup>142</sup> The e-mails suggested that, based on information purportedly obtained from a senior executive of a mystery company, the editor knew that the mystery company was going to announce a major transaction on May 22 and that investors could profit from buying the mystery company's stock prior to that time.<sup>143</sup> The e-mails further indicated that, for \$1000, an e-mail recipient could receive a special report divulging the name of the mystery company.<sup>144</sup> Pirate received over \$600,000 from sales of the special report to over 1200 investors.<sup>145</sup> Unfortunately for those who purchased the report and then purchased the stock of the mystery company, May 22 came and went without any announcement and it turned out that a mystery company senior executive had not told Pirate's editor that the transaction was to be announced on that date.<sup>146</sup>

To analyze whether the misrepresentations in Pirate's e-mails were "in connection with" a securities transaction for purposes of Rule 10b-5, the Fourth Circuit applied a multifactor test that focused on four factors that the court indicated are neither mandatory nor exhaustive, but rather serve as a guide.<sup>147</sup> According to the court, the

factors include, but are not limited to: (1) whether a securities sale was necessary to the completion of the fraudulent scheme; (2) whether the parties' relationship was such that it would necessarily involve trading in securities; (3) whether the defendant intended to induce a securities transaction; and (4) whether material misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely.<sup>148</sup>

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141. *S.E.C. v. Pirate Investor LLC*, 580 F.3d 233, 236 (4th Cir. 2009).

142. *Id.* at 237–39.

143. *Id.* at 238.

144. *Id.*

145. *Id.* at 239. The opinion does not explain why Pirate received only a portion of the total net proceeds from the sales. *See id.* (noting that Pirate received only \$626,500 of the total net proceeds of \$1,005,000).

146. *Id.* at 240.

147. *Id.* at 244.

148. *Id.* (internal quotation marks omitted).

The first factor, of course, is *Zandford's* misappropriation test.<sup>149</sup> The second factor is from the Third Circuit's decision in *Rowinski v. Salomon Smith Barney Inc.*<sup>150</sup> The Tenth Circuit's decision in *United International Holdings, Inc. v. Wharf (Holdings), Inc.* supports the third factor.<sup>151</sup> And the final factor is drawn from *Semerenko v. Cendant Corp.*, another Third Circuit case.<sup>152</sup>

The Fourth Circuit considered the various factors one-by-one, ultimately finding that Pirate's misrepresentations were "in connection with" the purchase or sale of security.<sup>153</sup> Although the court's conclusion was correct, it applied the factors indiscriminately, without reflection on what the factors measure or how they should apply. If, instead, the Fourth Circuit had used the intent-based principle described in Part II.C to construct and apply its test, the court would have reached the right conclusion more logically and efficiently. An examination of the cases supporting each factor in the *Pirate Investor* framework and of the Fourth Circuit's analysis with respect to each factor reveals where the court went wrong and how its multifactor test can be improved and better applied.

#### A. *Securities Sale Necessary to Complete the Fraud*

The Fourth Circuit looked to *Zandford's* misappropriation test—whether a securities transaction is necessary to complete the fraud—for its first factor and, considering the factor relative to the facts in *Pirate Investor*, determined that the factor weighed in favor of finding that Pirate's misrepresentations were "in connection with" a securities transaction. The court explained that Pirate sent out its e-mail in multiple waves.<sup>154</sup> According to the court, the e-mails in later waves touted stock purchases by investors who had received earlier e-mails and highlighted the fact that the mystery company's stock price had risen, which the

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149. *Id.* (citing *S.E.C. v. Zandford*, 535 U.S. 813, 820–21 (2002)).

150. *Id.* (citing *Rowinski v. Salomon Smith Barney, Inc.*, 398 F.3d 294, 302–03 (3d Cir. 2005)).

151. *Id.* (citing *United Int'l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1221 (10th Cir. 2000)).

152. *Id.* (citing *Semerenko v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000)).

153. *Id.* at 252.

154. *Id.* at 245.

district court found resulted from the earlier purchases.<sup>155</sup> Based on these facts, the court concluded that “[t]he fraud was not complete when investors paid \$1,000 to learn the identity of the company in question; [the defendants] also needed those investors to purchase the stock thereby increasing the stock price so as to boost the credibility of the solicitation e-mail to obtain more \$1,000 payments.”<sup>156</sup>

The Fourth Circuit’s analysis of the first factor is a bit contrived. While it may be true that Pirate *benefited* from actual purchases of the mystery company’s stock, by no means were the purchases *necessary* to complete the fraud. The fraud with respect to each investor was complete when the investor paid for the special report that revealed the identity of the mystery company. Unlike the misappropriation in *Zandford*, no intervening securities transaction was necessary to complete the fraud. Purchases by earlier investors may have aided Pirate in defrauding later investors, but purchases of the special reports by later investors could have been completed without anyone’s having made a purchase.

To reach the conclusion that securities transactions were necessary to complete the fraud, the Fourth Circuit stretched to characterize the “fraudulent scheme” as broadly as possible. Even when using such a broad characterization, the court struggled to conclude that purchases of the mystery company’s securities were *necessary* to complete Pirate’s fraud. In various places, the court stated that the defendants “*benefit[ted]* from securities trading by the purchasers of [Pirate’s] Special Report,” that “the rising stock was *important* to the success of the scheme,” and that “securities transactions *helped* [the defendants] to maximize the profitability of their scheme.”<sup>157</sup> In only one place, however, did the court indicate that the defendants *needed* the securities transactions, and even there, the necessity wasn’t to complete the fraud, but to “increase[e] the stock price so as to boost the credibility of the solicitation e-mail.”<sup>158</sup> Furthermore, whether securities transactions actually would have boosted the credibility of the e-mails is subject to some

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155. *Id.* at 245–46.

156. *Id.* at 246.

157. *Id.* at 245–47 (emphasis added).

158. *Id.* at 246.

question. After all, the e-mails did not give the name of the mystery company and therefore recipients had no way to confirm the truth of what the e-mail stated about changes in the stock price.

The Fourth Circuit went astray with the first factor by applying it too rigidly. The Supreme Court has not suggested that the *Zandford* test ought to apply outside the misappropriation context, and the Fourth Circuit's tortured analysis suggests that it ought not be. The court in *Pirate Investor* failed to acknowledge that *Zandford* was a misappropriation case, that *Pirate Investor* was not, and that the applicability of a test may depend on context.

None of this is to say that the Fourth Circuit's considerations with respect to the first factor were without merit. Facts indicating that a defendant benefitted from misstatements or omissions certainly are relevant to determining whether the defendant intended to influence an investment decision. The lesson from *Pirate Investor*'s application of the first factor is that the *Zandford* test should be limited to misappropriation cases and, outside the misappropriation context, courts ought to use a more broadly tailored factor such as whether the defendant benefited from the misstatements or omissions.

### *B. Parties' Relationship Such That It Necessarily Involves Securities Trading*

*Pirate Investor* cites *Rowinski* in support of its second factor—"whether the parties' relationship was such that it would necessarily involve trading in securities."<sup>159</sup> In *Rowinski*, the Third Circuit considered whether State law claims for breach of contract, unjust enrichment, and violations of state consumer protection laws were preempted under the Securities Litigation Uniform Standards Act of 1998<sup>160</sup> (SLUSA).<sup>161</sup> SLUSA, under certain conditions, preempts State law class actions with respect to fraud "*in connection with* the purchase or sale of" securities.<sup>162</sup> In

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159. *Id.* at 244.

160. 15 U.S.C. §§ 77p, 78bb(f) (2006).

161. *Rowinski v. Salomon Smith Barney, Inc.*, 398 F.3d 294, 296 (3d Cir. 2005)).

162. 15 U.S.C. §§ 77p(b), 78bb(f)(1) (emphasis added). Congress enacted SLUSA to curb State-law class action lawsuits with respect to nationally traded

evaluating the plaintiffs' claims in *Rowinski*, the Third Circuit applied precedent with respect to the "in connection with" requirement under Rule 10b-5.<sup>163</sup> Therefore, *Rowinski* was a reasonable place for the Fourth Circuit to look in creating its test.

The plaintiffs in *Rowinski*, retail brokerage customers of Salomon Smith Barney (SSB), alleged that SSB had produced investment research reports that reflected overly favorable views of its investment banking clients in order to "reap hundreds of millions of dollars of investment banking fees" from those clients.<sup>164</sup> The plaintiffs accordingly sought to recover, together with other damages, brokerage fees paid by them to SSB.<sup>165</sup>

*Pirate Investor* cites *Rowinski* in support of a single factor, but the Third Circuit in fact employed its own multifactor "flexible framework" to determine whether the alleged misrepresentations met the "in connection with"

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securities that began to arise after Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA). 15 U.S.C. §§ 77z-1 and 78u-4; Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 82 (2006). In the PSLRA, Congress adopted a number of measures designed to curtail abuses in federal antifraud class action lawsuits involving nationally traded securities. *Id.* at 81. Among other things, PSLRA established stringent pleading requirements, limited damages and attorney's fees, allowed discovery to be stayed until any motion to dismiss was resolved, and penalized those bringing frivolous lawsuits. *Id.* 81–82. After PSLRA was enacted, plaintiffs started bringing securities class actions under State law to avoid PSLRA's restrictions. *Id.* at 82. SLUSA was designed to stop the proliferation of these lawsuits by providing for federal preemption of State law class actions brought on behalf of over 50 people in which a plaintiff alleges "a misrepresentation or omission of a material fact *in connection with* the purchase or sale of a covered security" or "that the defendant used or employed any manipulative or deceptive device or contrivance *in connection with* the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1) (emphasis added). For purposes of SLUSA, a "covered security" is "one traded nationally and listed on a regulated national exchange." *Dabit*, 547 U.S. at 83.

163. *Rowinski*, 398 F.3d at 299. Other courts have found that "'in connection with the purchase or sale' of a security under SLUSA covers the same range of activities that the SEC could prosecute as violations of § 10(b) and Rule 10b-5." *Instituto De Prevision Militar v. Merrill Lynch*, 546 F.3d 1340, 1348 (11th Cir. 2008); *Siepel v. Bank of Am., N.A.*, 526 F.3d 1122, 1127 (8th Cir. 2008); see *Dabit*, 547 U.S. at 85 (considering the meaning of "in connection with" in SLUSA and indicating that "when 'judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in [a] new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well.'") (citation omitted).

164. *Rowinski*, 398 F.3d at 296–97.

165. *Id.* at 297.

requirement.<sup>166</sup> The factors in the Third Circuit’s framework included:

first, whether the . . . class action allege[d] a ‘fraudulent scheme’ that ‘coincides’ with the purchase or sale of securities; second, whether the complaint allege[d] a material misrepresentation or omission ‘disseminated to the public in a medium upon which a reasonable investor would rely;’ [and] third, whether the nature of the parties’ relationship is such that it necessarily involves the purchase or sale of securities . . . .<sup>167</sup>

The court concluded that all three factors<sup>168</sup> supported preemption of the plaintiffs’ claims under SLUSA. First, the court found that securities transactions coincided with the fraud as contemplated by *Zandford* because the transactions were necessary to the success of the alleged fraud.<sup>169</sup> The court reasoned that, without the purchases, the share prices of SSB’s investment banking clients would not increase and, without increases in share prices, the clients would not benefit and “pay” SSB for that benefit by giving SSB investment banking business.<sup>170</sup> Second, without much discussion, the court determined that an investment research report represented a “medium upon which a reasonable investor would rely.”<sup>171</sup> Finally, and again with little elaboration, the court found that the essential purpose of a broker/investor relationship is to engage in securities transactions.<sup>172</sup>

The Third Circuit cited its prior decision in *Angelaastro v. Prudential-Bache Securities, Inc.* to support its consideration of and conclusion regarding the final factor—the factor that *Pirate Investor* drew from *Rowinski*.<sup>173</sup> In *Angelaastro*, the Third Circuit considered whether a broker’s alleged misrepresentations and nondisclosures with respect to the

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166. *Id.* at 302.

167. *Id.* (citations omitted).

168. The court also considered “whether the prayer for relief ‘connect[ed]’ the state law claims to the purchase or sale of securities.” *Id.* This factor is relevant to whether a particular fraud is “in connection with” a securities transaction for purposes of SLUSA, but does not make sense in the context of Rule 10b-5.

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* at 303.

173. *Id.* at 302–03.

terms of a margin account met Rule 10b-5's transactional nexus requirement.<sup>174</sup> The plaintiff claimed that Prudential-Bache Securities, Inc. had failed to disclose completely and accurately its margin account terms, including the interest rate to be charged and how interest charges would be computed,<sup>175</sup> and that these misrepresentations and omissions "induced her" to purchase securities on margin in violation of section 10(b) and Rule 10b-5.<sup>176</sup>

In considering whether Bache's alleged misrepresentations and omissions were "in connection with" a securities transaction, the Third Circuit noted that it previously had interpreted the "touching" concept set out in *Bankers Trust* as requiring a causal connection.<sup>177</sup> Such a causal connection, the court observed, can exist in the context of a course of dealing in securities and need not involve the value of particular securities.<sup>178</sup> The court limited its holding, however, noting the danger in adopting a rule under which section 10(b) and Rule 10b-5 that would encompass every loan transaction that happened to involve securities.<sup>179</sup>

*Angelaastro* supports consideration of the context in which a fraud occurs for purposes of the "in connection with" requirement, but more significantly indicates how that context should be considered. Importantly, the Third Circuit in *Angelaastro* was addressing a motion to dismiss and, based on the context of the alleged fraud (i.e., a brokerage relationship), only determined that it could not conclude, as a matter of law, that a causal connection did not exist between the alleged fraud and securities transactions.<sup>180</sup> The court did

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174. *Angelaastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 941 (3d Cir. 1985).

175. *Id.* at 944.

176. *Id.*

177. *Id.* at 943.

178. *Id.* at 944; *see also id.* at 943 (noting that courts have determined that churning claims are within the ambit of Rule 10b-5 and churning "does not concern the merits of the individual securities bought and sold but rather the excessiveness of the number of transactions in the aggregate.").

179. *See id.* at 945 ("Our holding . . . does not mean that every loan transaction in which a pledge of securities is involved or every bank loan for the purpose of purchasing securities is necessarily within the purview of section 10(b).").

180. *Id.* ("We therefore reject Bache's assertion that, as a matter of law, plaintiff could prove no set of facts to demonstrate a connection between the credit terms of a margin account and her decision to purchase securities on margin.").

not find that, because the relationship involved the trading of securities, the fraud met the “in connection with” requirement. In fact, the court was very clear that consideration of the context in which a fraud occurs should not be taken too far:

We agree that there is a danger in construing the ‘in connection with’ requirement so broadly that virtually any type of misconduct related to a securities transaction even in the most tenuous or tangential way might be claimed to give rise to a federal securities law violation. . . . Our holding that the misrepresentations alleged by Angelastro regarding her margin account are cognizable under Rule 10b-5 does not mean that every loan transaction in which a pledge of securities is involved or every bank loan for the purpose of purchasing securities is necessarily within the purview of section 10(b).<sup>181</sup>

For *Angelastro*, then, context was significant only to the extent that it evidenced a “causal connection between the alleged misrepresentation and the harm incurred when a security is purchased or sold.”<sup>182</sup>

In *Pirate Investor*, the Fourth Circuit determined that the relationships involved did not necessitate securities transactions, and therefore the second factor of its test did not weigh in favor of finding that the fraud was “in connection with” a securities transaction. The defendants in *Pirate Investor* were merely selling advice; the decision to purchase securities entirely was in the hands of the recipients of the e-mails.<sup>183</sup> Accordingly, the court noted that the relationship between *Pirate* and the recipients differed from the brokerage relationship in *Zandford*, whose “very purpose . . . [was] trading in securities.”<sup>184</sup>

Significantly, the holding in *Zandford* was not based on the context in which the fraud occurred. In fact, the Supreme Court in *Zandford* was very clear that context itself is not dispositive. The Court noted specifically that, “[i]f, for example, a broker embezzles cash from a client’s account or takes advantage of the fiduciary relationship to induce his client into a fraudulent real estate transaction, then the fraud

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181. *Id.*

182. *Id.* at 944.

183. *S.E.C. v. Pirate Investor LLC*, 580 F.3d 233, 247 (4th Cir. 2009).

184. *Id.* at 247.



would not include the requisite connection to a purchase or sale of securities.”<sup>185</sup> This conduct the Court described is not actionable under Rule 10b-5 notwithstanding the fact the relationship between the broker and the client is one that necessarily involves trading in securities.

The Fourth Circuit was right to include consideration of the relationship between the applicable parties as a factor in its test. As *Angelaastro* suggests and *Zandford* confirms, however, the parties’ relationship is relevant only to the extent that it sheds light on the general principle governing the “in connection with” requirement. Accordingly, *Pirate Investor’s* second factor is important only to the extent that it indicates whether the perpetrator of the fraud intended to influence, or knew or was reckless in not knowing that his or her actions could influence, an investment decision.

### C. Defendant Induced Securities Transaction

*Pirate Investor* cites *United International Holdings, Inc. v. Wharf (Holdings) Ltd.*<sup>186</sup> in support of its third factor—“whether the defendant intended to induce a securities transaction.”<sup>187</sup> In *Wharf*, United International Holdings, Inc. (UIH) alleged that Wharf (Holdings) Ltd. had made representations that induced UIH to purchase from Wharf an option to purchase stock in a company that would operate a cable television system in Hong Kong.<sup>188</sup>

Wharf asserted that the alleged misrepresentations related to Wharf’s intent to sell the stock subject to the option and that such misrepresentations did not meet the “in connection with” requirement under Rule 10b-5.<sup>189</sup> The Tenth Circuit disagreed, citing precedent that found a valid Rule 10b-5 claim when a party agrees to sell a security while holding a “secret reservation” not to do so.<sup>190</sup> According to the

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185. *S.E.C. v. Zandford*, 535 U.S. 813, 825 n.4 (2002).

186. *United Int’l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207 (10th Cir. 2000).

187. *Pirate Investor*, 580 F.3d at 244.

188. *Wharf*, 210 F.3d at 1214, 1221.

189. *Id.* at 1221.

190. *Id.* (citing *In re Phillips Petroleum Secs. Litig.*, 881 F.3d 1236, 1245 n.13 (3d Cir. 1989); *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986); *Threadgill v. Black*, 730 F.2d 810, 811–12 (D.C. Cir. 1984); *Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971); *Mills v. Polar Molecular Corp.* 12 F.3d 1170, 1176 (2d Cir. 1993)).

court, “[i]t is a party’s secret reservation not to fully perform a securities contract that distinguishes these cases from routine breach of contract and common law fraud cases and brings them within the scope of Rule 10b-5.”<sup>191</sup> The court observed that “[Wharf’s] representations allegedly were made to induce UIH to purchase the option” and found that, as a consequence, “the misrepresentations were made to influence UIH’s investment decision and were made in connection with the purchase or sale of a security.”<sup>192</sup>

The court in *Pirate Investor* determined that the defendants intended to induce securities trades and therefore the third factor in *Pirate Investor*’s test indicated that Pirate’s misrepresentations were “in connection with” securities transactions.<sup>193</sup> In reaching this conclusion, the Fourth Circuit focused on two facts. First, the defendants benefitted from securities purchases, and second, the special report, which was provided after the investors paid \$1000, repeated claims about the mystery company’s major transaction and the timing of its announcement and “called upon investors to ‘call your broker now and tell him to buy shares of [the mystery company].’”<sup>194</sup>

Just as it did with respect to its first factor, the Fourth Circuit had to stretch to conclude that the defendants intended to induce a securities transaction. The court didn’t need to do so. In *Wharf*, the Tenth Circuit determined that, if the defendant intended to induce a securities transaction, it by definition met the applicable and broader principle that the fraud was intended to influence an investment decision.<sup>195</sup> At bottom, the Fourth Circuit’s third factor is just a narrower definition of an intent-based interpretation of the “in connection with” requirement. With the broader principle articulated in Part II.C., the court’s third factor is unnecessary.

Again, the Fourth Circuit’s focus on the benefit to the defendants is an important consideration. With the

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191. *Id.*

192. *Id.*

193. S.E.C. v. *Pirate Investor LLC*, 580 F.3d 233, 248 (4th Cir. 2009).

194. *Id.*

195. *See Wharf*, 210 F.3d at 1221 (“The representations allegedly were made to induce UIH to purchase the option. As such, the misrepresentations were made to influence UIH’s investment decision and were made in connection with the purchase or sale of a security.”).

modification proposed to the first factor of the *Pirate Investor* test, benefit will be taken into account in determining whether the perpetrator of the fraud intended to influence, or knew or was reckless in not knowing that his or her actions could influence, an investment decision.

Although *Pirate Investor*'s third factor is redundant when coupled with the general principle from Part II.C, the court's analysis with respect to the factor suggests an additional factor: "whether, through written or spoken words or other conduct, the defendant encouraged a securities transaction." The language in *Pirate*'s special report urging investors to call their brokers and ask them to purchase stock in the mystery company certainly suggests that *Pirate* intended to influence the recipients' investment decisions. Considering the presence or absence of similar language in other cases will assist courts in gauging whether a defendant had the requisite intent to satisfy Rule 10b-5's transactional nexus requirement.

*D. Misrepresentations Disseminated in a Medium Upon Which a Reasonable Investor Would Rely*

*Pirate Investor* looked to *Semerenko v. Cendant Corp.* to support its final factor—"whether material misrepresentations were 'disseminated to the public in a medium upon which a reasonable investor would rely.'"<sup>196</sup> In *Semerenko*, the Third Circuit considered whether alleged misrepresentations made by an acquiring company in a tender offer were "in connection with" purchases and sales of the target's common stock.<sup>197</sup> In 1998, *Cendant Corp.* commenced a tender offer for all of the outstanding shares of common stock of American Bankers Insurance Group, Inc. (ABI).<sup>198</sup> After two bids, *Cendant* entered into an agreement to acquire ABI for a combination of cash and common stock.<sup>199</sup>

Shortly after entering into the agreement, *Cendant* disclosed possible accounting irregularities affecting its earnings for the previous fiscal year and announced that an

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196. *Pirate Investor*, 580 F.3d at 244 (quoting *Semerenko v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000) ("public dissemination of information in a medium upon which an investor would presumably rely")).

197. *Semerenko*, 223 F.3d at 169.

198. *Id.* at 170.

199. *Id.*

independent investigation of the problems was to be conducted.<sup>200</sup> In a letter to Cendant's shareholders following the announcement, Cendant's chairman and its chief executive officer indicated that Cendant was committed to completing the ABI acquisition.<sup>201</sup> The company later announced that the effect on its prior year earnings would be more than double its original estimate and that it had detected additional irregularities affecting other fiscal years.<sup>202</sup> Nevertheless, Cendant continued to make public statements indicating that it remained committed to acquiring ABI.<sup>203</sup> After the full effect of the irregularities was disclosed, however, Cendant terminated its agreement to acquire ABI.<sup>204</sup> In a class action lawsuit filed the day after Cendant terminated the agreement, shareholders who purchased ABI shares between the time Cendant made its first tender offer bid and the time it terminated its agreement with AGI claimed that Cendant, former officers and directors of the company, and Ernst & Young, the company's auditor, had violated Rule 10b-5 by misrepresenting Cendant's financial condition and its commitment to acquiring ABI.<sup>205</sup>

In considering whether the alleged misrepresentations met Rule 10b-5's transactional nexus requirement, the Third Circuit acknowledged that, in *Angelaastro*, it had required a "causal connection between the claimed fraud and the purchase or sale of a security."<sup>206</sup> Bearing that in mind, the court held that, when misrepresentations are publicly disseminated into an efficient market, a plaintiff may meet the "in connection with" requirement "simply by showing that the misrepresentations in question were disseminated to the public in a medium upon which a reasonable investor would rely, and that they were material when disseminated."<sup>207</sup> Moreover, the court explained that the standard can be met even if the person making the misrepresentation did not intend to influence an investment decision.<sup>208</sup> "Rather, [the

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200. *Id.*

201. *Id.*

202. *Id.* at 171.

203. *Id.*

204. *Id.*

205. *Id.* at 169, 171.

206. *Id.* at 175.

207. *Id.* at 176.

208. *Id.*

plaintiff] must only show that the . . . misrepresentation[] [was] reckless.”<sup>209</sup> As to an accountant’s liability, the Third Circuit held that the plaintiff must make an additional showing that the defendant knew or had reason to know that the applicable financial statements and the related audit reports would be used in a securities transaction.<sup>210</sup> The court established these transactional nexus standards, but stopped there, noting that it needed to remand the case because the standards it articulated were different from the standard the district court had applied.<sup>211</sup>

The Third Circuit in *Semerenko* indicated that it was adopting a standard like the one adopted by the United States Court of Appeals for the Second Circuit in *Ames* and by the United States Court of Appeals for the Ninth Circuit in *McGann v. Ernst & Young* with respect to publicly disseminated information.<sup>212</sup> In *In re Ames Department Stores Inc. Stock Litigation*, the Second Circuit considered whether alleged misrepresentations made in offering documents for an issuer’s debt offerings were “in connection with” transactions in the issuer’s common stock for purposes of Rule 10b-5.<sup>213</sup> Ames Department Stores, Inc. acquired a division of Zayre Corporation in 1988.<sup>214</sup> Although Ames was having difficulty integrating the Zayre division into the company, Ames made statements in offering documents for two debt offerings that indicated the integration was going well.<sup>215</sup> In addition, the offering documents included positive statements about Ames’s financial condition following the acquisition.<sup>216</sup> Ames ultimately filed for bankruptcy.<sup>217</sup>

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209. *Id.*

210. *Id.* at 177.

211. *Id.*

212. *Id.* at 176.

213. See *In re Ames Dep’t Stores Inc. Stock Litig.*, 991 F.2d 953, 961 (2d Cir. 1993) (noting that the district court had considered whether alleged misrepresentations in prospectuses for reset notes and debentures could serve as the basis for Rule 10b-5 liability with respect to stock purchases).

214. *Id.* at 955.

215. *Id.* at 958–60.

216. See *id.* at 958 (indicating that the 1989 annual report, which was incorporated by reference in the reset note prospectus, predicted a 150% increase in sales); see also *id.* at 959–60 (stating that the prospectus for the debentures indicated that Ames had reduced overhead, “reassured investors that anticipated strong sales . . . would enable Ames to meet its selling goals” in the holiday season, and asserted that its revolving credit facility was sufficient to meet its working capital and capital expenditure needs).

Looking to the flexible standard cited in *Bankers Life* and to its earlier decision in *SEC v. Texas Gulf Sulphur*, the Second Circuit determined that misrepresentations made in the offering documents for Ames's debt securities could operate as a fraud subject to Rule 10b-5 with respect to transactions in Ames's common stock.<sup>218</sup> The court noted that, under *Texas Gulf Sulphur's* test, to be "in connection with" a securities transaction, a fraudulent device needed to be of a type on which reasonable investors would rely and which, in such reliance, would cause them to purchase or sell securities.<sup>219</sup> Observing that *Texas Gulf Sulphur's* "in connection with" test was akin to its test for materiality, the Second Circuit in *Ames* suggested that "any material information issued by a corporation (whose securities are publicly traded) has appropriate 'connection' to constitute a 10b-5 violation if the information is misleading."<sup>220</sup> The court noted, moreover, that the offering documents for Ames's debt securities were just the type of documents that a reasonable investor would use to evaluate an investment in the company's common stock.<sup>221</sup>

The court in *Ames* rejected the defendants' argument that *Texas Gulf Sulphur* required, for fraudulent statements to be "in connection with" a securities transaction, that an effect on investor decision-making be "not only reasonably foreseeable, but also envisioned by the company."<sup>222</sup> In so doing, the Third Circuit noted that not only intentional conduct, but also reckless conduct, is proscribed by Rule 10b-5.<sup>223</sup>

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217. *Id.* at 961.

218. *Id.* at 964–65 (citing *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971) and *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *see id.* at 961 (indicating that the district court had incorrectly "construed the 'in connection with' requirement as requiring that the [mis]statements be made in the registration statements for the particular stock at issue"). The plaintiffs in *Ames* also alleged that misstatements had been made in various publicly disseminated statements, such as press releases and periodic SEC filings, but the district court only considered the documents associated with the debt offerings. *See id.* at 968. The Second Circuit indicated that the alleged misstatements in those publicly disseminated documents would support a Rule 10b-5 cause of action even if the debt offering documents did not. *Id.*

219. *Id.* at 965.

220. *Id.*

221. *Id.*

222. *Id.*

223. *Id.*

In *McGann v. Ernst & Young*, the Ninth Circuit considered whether an auditing firm that knew its audit opinion would be included in a client's Form 10-K could be liable under Rule 10b-5 with respect to the opinion.<sup>224</sup> Ernst & Young had issued an audit opinion with respect to the 1990 financial statements of Community Psychiatric Centers, and the plaintiffs alleged that the opinion was fraudulent because it did not disclose that the corporation had substantial uncollectible accounts.<sup>225</sup>

In evaluating whether the alleged fraud could meet the "in connection with" requirement, the Ninth Circuit indicated that it had adopted the standard set out in *Texas Gulf Sulphur* that "false and misleading assertions are made 'in connection with' securities trading 'whenever [such] assertions are made . . . in a manner reasonably calculated to influence the investing public.'"<sup>226</sup> The court then determined that an accountant that gives a fraudulent audit opinion, knowing that it will be included in a Form 10-K, meets the requirements of the *Texas Gulf Sulphur* standard.<sup>227</sup> According to the court, "[w]hile an outside accounting firm might be blameless where it had no reason to know that its client would use its audit report to sell securities, or where it instructed its client not to release the report to the public," that was not the case for Ernst & Young.<sup>228</sup>

With respect to its final factor, the Fourth Circuit in *Pirate Investor* determined that the defendants distributed their misrepresentations through a medium "on which a reasonable investor would rely."<sup>229</sup> In reaching this conclusion, the court cited *Texas Gulf Sulphur's* determination that a misrepresentation is within the scope of Rule 10b-5 when it is made "in a manner reasonably calculated to influence the investing public."<sup>230</sup> The court noted that the *Texas Gulf Sulphur* standard had been refined by several circuits such that, for the SEC to establish that a misrepresentation is "in connection with" a securities

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224. *McGann v. Ernst & Young*, 102 F.3d 390, 391 (9th Cir. 1996).

225. *Id.*

226. *Id.* at 392-93.

227. *Id.* at 397.

228. *Id.*

229. *S.E.C. v. Pirate Investor LLC*, 580 F.3d 233, 244 (4th Cir. 2009).

230. *Id.* at 249 (citing *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968)).

transaction, the SEC must establish that “(1) the misrepresentation[] . . . [was] disseminated to the public in a medium upon which a reasonable investor would rely and (2) [the misrepresentation was] material when disseminated.”<sup>231</sup> The court noted, however, that an e-mail is not a medium of the same type as those considered sufficient by other courts and that one typically would not expect a reasonable investor to rely on an e-mail.<sup>232</sup> The court nevertheless found compelling the fact that, because the defendants targeted investors who subscribed to internet investment newsletters and who therefore put faith in investment advice received on the internet, the defendants “*knew* that they were directing their misstatements to particular investors who *did rely* on internet investment advice.”<sup>233</sup>

*Pirate Investor*'s fourth factor is a longstanding test and is very useful for measuring when a fraud satisfies the general principle described in Part II.C. How a defendant disseminates a misrepresentation certainly gives insight into whether he or she intended to influence, or knew or was reckless in not knowing that his or her actions could influence, an investment decision. Courts should be careful, however, not to apply the factor too narrowly. It is quite possible, as in an e-mail of the type used in *Pirate Investor*, that a perpetrator of a fraud could intend to influence an investment decision even when it uses a means on which a reasonable investor *might not* rely. *Pirate Investor* seems to suggest that, if *Pirate* had distributed its e-mail more broadly, the fourth factor might not weigh in favor of finding the requisite transactional nexus for Rule 10b-5. This, it seems, would be a mistake. If a person intended to influence an investment decision, the fact that the means are unusual should not alter the determination that the required connection exists.

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231. *Id.* (citing *Semerenco v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000)).

232. *Id.* at 250 (noting that other courts have applied the standard to “research reports from a reputable broker; prospectuses; the sales and marketing materials at brokerage houses and other points of sale; SEC filings; and detailed drug advertisements published in sophisticated medical journals.”) (citations omitted).

233. *Id.* at 251.



## CONCLUSION

In *Ames*, the Second Circuit observed that *Bankers Trust's* broad interpretation of the “in connection with” requirement has obscured the analysis appropriate for “straightforward” securities fraud cases,<sup>234</sup> and it warned that cases at the fringes should not affect the analysis of ordinary frauds, which affect market integrity.<sup>235</sup> The fraud at issue in *Pirate Investor* certainly threatened market integrity, and the Fourth Circuit’s indiscriminate application of its multifactor framework bordered on the type of errant analysis warned about by *Ames*.

The Fourth Circuit’s framework for analyzing Rule 10b-5 “in connection with” requirement nevertheless offers a good start for approaching the requirement. When guided by a general principle supported by Supreme Court precedent and molded to be consistent the principle’s contours, *Pirate Investor’s* multifactor test offers a methodical and workable means for considering whether a fraud meets the transactional nexus requirement.

Accordingly, courts should determine that a fraud is “in connection with” the purchase or sale of a security for purposes of Rule 10b-5 only when the perpetrator of the fraud intended to influence, or knew or was reckless in not knowing that his or her actions could influence, an investment decision. In making this determination in a misappropriation case, courts should consider—as the Supreme Court has commanded—whether a securities transaction was necessary to complete the fraud. With respect to other types of fraud, however, courts should apply the following non-exclusive and non-mandatory factors, which have been derived from *Pirate Investor* and modified and supplemented as described above:

- whether the defendant benefited from the misstatements or omissions;
- whether the parties’ relationship was such that it would necessarily involve trading in securities;
- whether, through written or spoken words or other conduct, the defendant encouraged a

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234. *See In re Ames Dep’t Stores Inc. Stock Litig.*, 991 F.2d 953, 966 (2d Cir. 1993) (stating that frauds involving face-to-face transactions are atypical and “pose analytical difficulties not present in a straightforward case” like *Ames*).

235. *Id.*

securities transaction; and

- whether material misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely.

Such an approach to Rule 10b-5's "in connection with" requirement is clear and logical. It might even satisfy Judge Posner.