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The "In Connection With" Requirement of Rule 10b-5

C. Edward Fletcher III

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The "In Connection With" Requirement of Rule 10b-5

C. Edward Fletcher, III*

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I. INTRODUCTION

Notwithstanding the level of detail and complexity attained in many legal texts, any judge will agree that occasionally a statute or administrative rule offers little guidance as to its appropriate application to actual fact patterns. This dissonance should be the cause of neither surprise nor dismay. Some lack of guidance is a natural outgrowth as drafters of legal texts cannot foresee all possible future fact patterns. For this reason their rules tend to be general. After all, it is precisely the function of a judge to help the law bridge the gap from legal principles and texts to fact situations. If legal rules were self-articulating, human judges would be unnecessary in most cases; computers can solve simple syllogisms.

Nonetheless, it is true that some legal rules are more deficient in the guidance they offer than others. That quite naturally leads to litigation concerning the meaning of the text. One such text is rule 10b-5 (10b-5),¹ promulgated under section 10(b)² of the Securities Ex-

1. Rule 10b-5 provides:

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

change Act of 1934 (the 1934 Act).³ The rule is drafted in a manner seemingly calculated to produce disputes over its interpretation; if that is what the drafters intended, their wishes have been long fulfilled. The quantity of interpretive law on nearly every aspect of 10b-5 is staggering.⁴

The purpose of this article is to sort through one particularly confusing area of rule 10b-5 in order to develop a coherent and correct understanding of that part of the law. The topic of this article is the requirement that the deceptive or manipulative act⁵ be "in connection with" the purchase or sale of securities. Because of the way in which 10b-5 is formulated, it is not enough that the defendant have committed one of the many "bad acts" thought to be actionable under the rule. Rather, the defendant's bad act must have been made "*in connection with* the purchase or sale of . . . securit[ies]."⁶ Neither

- (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.

17 C.F.R. § 240.10b-5 (1988).

2. Section 10 states in relevant part:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1982).

3. Pub. L. No. 291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-kk (1982 & Supp. IV 1986)).

4. Aside from the massive number of cases decided under rule 10b-5 and the startling quantity of literature in the journals, there are at least two treatises devoted primarily to rule 10b-5. See A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* (1979); A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5* (2d ed. 1981). The development of this jurisprudence has been briefly traced elsewhere. See Fletcher, *Learning to Live With the Federal Arbitration Act—Securities Litigation in a Post-McMahon World*, 37 EMORY L.J. 99, 126 n.147 (1988).

5. Rule 10b-5 itself purports to proscribe much more than deceptive and manipulative acts. The Supreme Court has pointed out that the rule can proscribe no more than that prohibited by section 10(b), which the rule seeks to interpret; section 10(b) proscribes only deceptive and manipulative acts. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 472-74 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976).

6. 17 C.F.R. § 240.10b-5 (1988) (emphasis added); see L. SODERQUIST, *UNDERSTANDING THE SECURITIES LAWS* 252 (1987).

fraud nor the purchase or sale of securities will yield a 10b-5 violation unless the fraud was in connection with the purchase or sale. This article addresses the problem involved in determining when the fraud is in fact in connection with a purchase or sale of securities.

The problem can be best understood by looking at two hypothetical scenarios. In scenario A, imagine a vendor of common stocks. The vendor is in the business of selling shares of stock in publicly held corporations. In an effort to induce a victim into buying some shares in XYZ Corporation, the vendor lies to the victim by stating that XYZ Corporation is a major computer manufacturer whose sales and earnings have doubled every year for the past ten years. In fact, the vendor knows that XYZ is a shell corporation with no present assets, sales, or earnings history and no prospects for any in the future. In reliance on the lies, the victim buys XYZ Corporation stock from the vendor.

In scenario B, imagine a shoe salesman who is also an active stock trader. The salesman often knowingly and intentionally lies to his customers about the quality of the leather in the shoes he sells. In reliance on these lies many customers buy his shoddy shoes. The salesman also sometimes sells securities to his shoe customers. However, the salesman is scrupulously honest when it comes to buying and selling securities, making truthful and complete disclosure to the extent the law requires.

In scenario A, the vendor has committed a clear violation of 10b-5;⁷ in scenario B, the shoe salesman has clearly not violated 10b-5. Yet in both cases, fraud exists in the form of misrepresentations with scienter, and a sale of securities has been consummated. The element present in scenario A which is absent in scenario B is a link between the two. In scenario B, the fraud was simply not in connection with the sale of securities.

The challenge posed by the "in connection with" requirement of 10b-5 is coming up with a legitimating theory that will separate the scenario A's of the world from the scenario B's. These two scenarios are simple because they exist at the opposite ends of the "in connection with" spectrum. The task of creating and applying a rational "in

7. Courts, understandably, have never had any trouble coming to the conclusion that a person's misrepresentations concerning a security, made in an attempt to sell the security at a higher price than would be otherwise attainable, is deception "in connection with" the sale of the security. *See, e.g.,* *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) (false prospectus and registration statement); *Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339, 362-63 (N.D. Ohio 1976) (misleading statements in sales claims). *See generally* Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1292-95 (1965). The same is true of misrepresentations made for purposes of inducing securities holders to sell. *See, e.g.,* *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228, 1236-38 (D. Del. 1978) (deceptive tender offers).

connection with" theory becomes more difficult as factual situations approach the middle of the spectrum. The purpose of this article is to create a theory of the "in connection with" requirement that will explain adequately the difference between scenario A and B, as well as those scenarios in the center of the spectrum. Up to now, there has been only confusion on this point,⁸ a fact bemoaned by many judges⁹ and commentators.¹⁰

The importance of the "in connection with" requirement is heightened because it appears in other statutory contexts as well; for example, section 14(e) of the 1934 Act proscribes fraudulent conduct in connection with tender offers.¹¹ Although this article will focus exclusively on 10b-5, much of what will be said can be applied to the tender offer context as well.

Part II of this article sets the stage for a discussion of the "in connection with" requirement by making clear the relationship of that requirement to other elements of the 10b-5 offense. Part III then presents a chronology of the development of the "in connection with" requirement, demonstrating an expansion and contraction that parallels that of 10b-5's scope as interpreted by the judiciary.

Part IV offers a topical analysis of the "in connection with" requirement, demonstrating that much of the difficulty in interpretation stems from the multiplicity of fact situations in which the requirement arises. This problem has been exacerbated by an apparent unawareness by the judiciary that the "in connection with" requirement necessarily calls upon judges to vary their analyses depending upon the type of case involved. For example, corporate mismanagement cases must be treated differently from misappropriation/insider trading cases when analyzing the degree of connection

8. There have been a few attempts to sort through the confusion. See, e.g., Note, *SEC Rule 10b-5—"In Connection With the Purchase or Sale of Any Security" Restriction: Need for Analytical Precision*, 5 COLUM. J.L. & SOC. PROBS. No. 2, 28 (1969); Note, *The Pendulum Swings Farther: The "In Connection With" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages*, 56 TEX. L. REV. 62 (1977) [hereinafter Note, *The Pendulum Swings Farther*].

9. See, e.g., *Buffo v. Graddick*, 742 F.2d 592, 596 (11th Cir. 1984); *Liberty Nat'l Ins. Holding Co. v. The Charter Co.*, 734 F.2d 545, 555 (11th Cir. 1984); *Rand v. Anaconda Ericsson, Inc.*, 623 F. Supp. 176, 185 (E.D.N.Y. 1985), *aff'd*, 794 F.2d 843 (2d Cir.), *cert. denied*, 107 S. Ct. 579 (1986).

10. See, e.g., 5 A. JACOBS, *supra* note 4, § 38.01, at 2-41; L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 903-04 (1983); R. JENNINGS & H. MARSH, *SECURITIES REGULATION: CASES AND MATERIALS* 1047 (5th ed. 1982); Note, *The Pendulum Swings Farther*, *supra* note 8, at 68-69.

11. See 15 U.S.C. § 78(n)(e) (1982).

between the deception and the purchase or sale of securities. This point is discussed more fully below.¹²

Part V sorts through the various analyses by courts and commentators and draws principles of distinction between those cases in which the fraud is in connection with the purchase or sale of securities from those cases in which the necessary connection is lacking. Part V also offers guidance for the future interpretation of the "in connection with" requirement in various factual settings.

Finally, part VI concludes that the interpretive conundrum presented by the "in connection with" requirement results from an unfortunate promulgation of substanceless legal rules by Congress and the Securities and Exchange Commission (SEC). These rules force judges to assume a role they should not assume, impose uncertainty costs upon the mechanisms of capital formation, and fail to give notice to potential defendants (who may be criminally liable for violations of 10b-5) of the prospect of their liability under the federal securities laws. This article asserts that congressional or SEC action is needed to specify the type of connection required between the "fraud" involved and the purchase or sale of securities. Although the implications of some of the ideas presented are wide-reaching, and although broad questions are raised regarding statutory interpretation and the proper relationship between the judiciary and the legislature, this article does not set forth an elaborate theory about what types of activities involving securities should be prohibited. In a sense, the focus is much narrower: given the statute and the rule, how should courts interpret them? And given the confusion that reigns in the case law, what should Congress do about it?

II. THE RELATIONSHIP OF THE "IN CONNECTION WITH" REQUIREMENT TO OTHER ELEMENTS OF RULE 10B-5

To understand the "in connection with" requirement, one must understand its place in 10b-5 analysis. More specifically, one must understand how the "in connection with" requirement relates to six other elements of 10b-5. A comprehensive understanding of the relationship between those elements greatly facilitates the proper understanding of the "in connection with" requirement. Those six elements are: (1) the fraud element; (2) materiality; (3) the purchase or sale requirement; (4) causation; (5) reliance; and (6) damages.¹³

Broken down into its component parts, a private damage action under 10b-5 has several elements. There must be "fraud" in the

12. See *infra* notes 161-226 and accompanying text.

13. See Note, *The Pendulum Swings Farther*, *supra* note 8, at 71-72 (citations omitted).

sense of either deception or manipulation.¹⁴ Since "manipulation" is "virtually a term of art" describing such practices as false touts and matched buy/sell orders,¹⁵ most 10b-5 fraud involves deception. The deception cases require, as a subset of the fraud element, that the deception be material—that is, a "reasonable [person] would attach importance [to the fact represented] in determining his choice of action in the transaction in question."¹⁶ In addition, of course, after *Ernst & Ernst v. Hochfelder*¹⁷ and *Aaron v. Securities and Exchange Commission*,¹⁸ the deception must have been made with scienter to satisfy the fraud element.

In *Blue Chip Stamps v. Manor Drug Stores*,¹⁹ the United States Supreme Court held that a plaintiff in a 10b-5 action must have actually purchased or sold securities,²⁰ firmly imbedding another element—the purchaser/seller requirement—into 10b-5 actions. Because of 10b-5's textual requirement that the fraud involved be in connection with "the purchase or sale of any security",²¹ the purchaser/seller requirement clearly extends to SEC enforcement actions and criminal actions, as well as private damage actions represented by *Blue Chip Stamps*.²² The rule requires that there be a purchase or sale; *Blue Chip Stamps* requires that the plaintiff in a private damage action be the purchaser or seller.

The other elements of the 10b-5 private damage action are not required in criminal or SEC enforcement actions. Two of them—reliance and causation—are intimately tied to one another. More specifically, reliance is a subset of the causation requirement. The plaintiff generally establishes causation by showing that he relied on

14. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 473-74 (1977).

15. See *id.* at 476 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)).

16. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811 (1965); *accord Little v. Valley Nat'l Bank*, 650 F.2d 218, 222 (9th Cir. 1981) (Facts are material if "there is a substantial likelihood that an ordinary investor would have considered them important in deciding whether or not to purchase the securities."). See also *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963) (stating materiality encompasses those facts that "in reasonable and objective contemplation might affect the value of the corporation's stock or securities").

17. 425 U.S. 185 (1976).

18. 446 U.S. 680 (1980).

19. 421 U.S. 723 (1975).

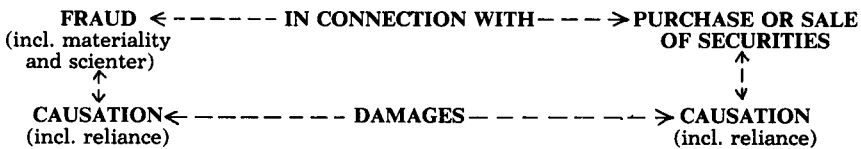
20. *Id.* at 754-55.

21. 17 C.F.R. § 240.10b-5 (1988).

22. Thus, *Blue Chip Stamps* is best seen as imposing a non-textually based standing requirement. See generally T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 13.3, at 450-57 (1985).

the alleged misrepresentation involved.²³ There are exceptions, for example, when the deception occurs as a result of non-disclosure²⁴ or when the plaintiff alleges fraud on the market.²⁵ In such cases, a showing of reliance is unnecessary to establish the causation element. Finally, for a private damage action to be successful, the plaintiff must plead and prove damages. That is, the thing "caused" must have been some harm to the plaintiff.²⁶

Having seen what the elements of the 10b-5 action are, an examination of their interrelationship and interplay with the "in connection with" requirement is appropriate. The following diagram illustrates the relationships between the elements:



The "in connection with" factor requires that there be a nexus between the alleged fraud and the purchase or sale of securities.²⁷ It is important to distinguish the role played by the "in connection with" requirement from that of causation and its subsidiary requirement, reliance.²⁸ Whereas the "in connection with" element requires a nexus between the fraud and the purchase or sale of securities, the causation element requires a nexus between the fraud and the damages or between the purchase or sale and the damages.²⁹

This distinction between the "in connection with" requirement and

23. See, e.g., *Gottreich v. San Francisco Inv. Corp.*, 552 F.2d 866, 869 (9th Cir. 1977) (stating that plaintiffs "relied on the misrepresentations; thus causation is adequately alleged").

24. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972) (materiality substitutes for reliance to establish causation where the deception was through non-disclosure, rather than affirmative misrepresentation, in face-to-face transactions).

25. In the "fraud on the market" theory, the plaintiff establishes causation by proving that he relied on the market to set an accurate price for the security based on all available public information, and that the market relied on the misrepresentation of the defendants, setting a higher or lower price than the market would have set without the misrepresentation. See, e.g., *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986). See generally *T. HAZEN*, *supra* note 22, § 13.5, at 465-66 (describing fraud on the market theory and its basis in efficient market theory). In *Basic, Inc. v. Levinson*, 108 S. Ct. 978 (1988), a plurality of the United States Supreme Court adopted the fraud on the market theory.

26. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979).

27. See, e.g., *In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986); *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1315 (5th Cir. 1977); *Troyer v. Karcagi*, 476 F. Supp. 1142, 1148 (S.D.N.Y. 1979).

28. As pointed out above, in the proper case, materiality may do double duty as a subset of both the fraud element and the causation element. See *supra* note 25.

29. *Accord* 5 A. JACOBS, *supra* note 10, § 38.01[b], at 2-42.

the causation requirement was hinted at by Justice Douglas in *Superintendent of Insurance v. Bankers Life & Casualty Co.*:³⁰ "The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities . . ."³¹ The statement that the injury occurred "as a result of" deceptive practices concerns causation; the statement that the deceptive practices "touched" the sale of securities concerns the "in connection with" requirement.³²

The distinction is important not only to facilitate a conceptualization of the "in connection with" requirement and its place in 10b-5 analysis, but also to prevent potential confusion resulting from the infiltration of all the conceptual problems attending causation analysis in 10b-5 cases.³³ Proper segregation of causation from the "in connection with" analysis avoids this conundrum.

One recent case illustrates the confusion resulting from not sufficiently distinguishing causation and the "in connection with" requirement. In *Roberts v. Peat, Marwick, Mitchell & Co.*,³⁴ the Ninth Circuit confused the two requirements, stating that the "in connection with" element requires a "causal relationship between the fraud and the resulting injury."³⁵ This is obviously incorrect; the "in connection with" requirement is an element of both private damage actions and criminal or SEC enforcement actions. In the latter, no injury need be shown at all; thus, the "in connection with" requirement cannot require a showing of a causal connection to some injury.

Unfortunately, some courts and commentators have fostered confusion between the two elements of 10b-5 by treating the distinction as a difference between "loss causation" and "transaction causation."³⁶ What is described as "loss causation" is nothing more than an identification of the causal factor (*i.e.*, causation in the everyday sense);

30. 404 U.S. 6 (1971).

31. *Id.* at 12-13 (emphasis added).

32. See *Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339, 363 (N.D. Ohio 1976) (reporting argument of counsel).

33. See generally T. HAZEN, *supra* note 22, §§ 13.5-6, at 461-69; L. LOSS, *supra* note 10, at 1126-32; Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L. REV. 99 (1981).

34. 857 F.2d 646 (9th Cir. 1988).

35. *Id.* at 150 (citing *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 989 (1988)).

36. See, e.g., *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975); T. HAZEN, *supra* note 22, § 13.6, at 467; Crane, *supra* note 33, at 100; Note, *The Pendulum Swings Farther*, *supra* note 8, at 62-65. See generally Note, *Loss and Transaction Causation: The Second Circuit Resolves the Causation Controversy in Majority Control Situations*, 32 WASH. & LEE L. REV. 693 (1975).

“transaction causation” is simply a misleading phraseology describing the “in connection with” requirement. Professor Hazen’s description of the two supposed types of causation actually illustrates the two separate elements—causation and the “in connection with” requirement:

To begin with, the plaintiff must prove “transaction causation” which means that but for the wrongful conduct, the transaction would not have gone through. . . . Secondly, the plaintiff must be able to prove “loss causation”—namely that the plaintiff’s injury . . . is directly attributable to both the wrongful conduct and the form and manner in which the challenged transaction occurred.³⁷

Discussing the “in connection with” requirement in terms of “transaction causation” is misleading. As discussed at length below, the “in connection with” requirement entails much more (and sometimes much less) than causation. Perhaps for this reason, some observers understandably find the distinction between loss causation and transaction causation unhelpful.³⁸

III. HISTORICAL DEVELOPMENT OF THE “IN CONNECTION WITH” REQUIREMENT

Just as an appreciation of the relationship between the “in connection with” requirement and other elements of 10b-5 facilitates an understanding of the rule, awareness of the historical development of the “in connection with” requirement aids in understanding proper analysis of the requirement.

A. *The Legacy of Birnbaum v. Newport Steel Corp.*

Given that the “in connection with” requirement is the linchpin between fraudulent conduct and the purchase or sale of securities, and given the amount of litigation concerning the requirement, the fact that there is only one Supreme Court case addressing the requirement, the 1971 case of *Superintendent of Insurance v. Bankers Life & Casualty Co.*,³⁹ is astounding. Yet the history of the “in connection with” requirement began almost twenty years before, in the 1952 case of *Birnbaum v. Newport Steel Corp.*⁴⁰

Birnbaum is best known for holding that a plaintiff in a 10b-5 action must be an actual purchaser or seller of securities⁴¹—a holding

37. T. HAZEN, *supra* note 22, § 13.6, at 467.

38. See *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 n.11 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978); R. JENNINGS & H. MARSH, *supra* note 10, at 1047-48.

39. 404 U.S. 6 (1971). As discussed *infra* notes 71-80 and accompanying text, most recent cases, including the *Blue Chip Stamps* case, arguably cut back on *Bankers Life* significantly.

40. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

41. *Id.* at 463.

that was adopted by the Supreme Court in the *Blue Chip Stamps* case.⁴² However, the *Birnbaum* court went much further, concluding that 10b-5 is directed only at that type of misrepresentation or fraudulent practice normally associated with the sale or purchase of securities, not at corporate mismanagement, even if fraudulent.⁴³

There are two possible interpretations of this second holding. The first is as a non-textually based, policy-oriented limitation on 10b-5's application. That is, the court may have been limiting the application of 10b-5 in conformity with the perceived motivating principles for the rule.⁴⁴ But the court also seems to have been making two statements, one negative and one positive, about the "in connection with" requirement. First, the court seems to suggest that fraud will never be in connection with a purchase or sale of securities for purposes of 10b-5, if the fraud is nothing more than egregious corporate mismanagement actionable under state law. This view implies that *Birnbaum* is the doctrinal grandfather of modern interpretations of the "in connection with" requirement; which suggests that not just any fraud that happens to involve a purchase or sale of securities will satisfy the requirement.⁴⁵

The other, more positive statement seemingly made in *Birnbaum* concerns when the requirement *will* be satisfied. The court suggests that deception or manipulation will be in connection with the purchase or sale of securities only if that deception or manipulation is of a type "normally associated" with the purchase or sale of securities. This reading of the "in connection with" requirement has passed into obscurity in the current case law. Nonetheless, it represents an early attempt to define the scope of an intellectually baffling nexus requirement. As will be seen, the "normally associated" test of *Birnbaum* is just one of many that courts have used through the years.⁴⁶

B. The Supreme Court Speaks: Bankers Life and the "Touch" Test

Curiously, the most widely discussed "test" for determining when the "in connection with" requirement is satisfied was not intended to

42. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

43. *Birnbaum*, 193 F.2d at 464.

44. The proper use of background principles in the application of statutory texts is discussed elsewhere. See Fletcher, *Principlist Models in the Analysis of Constitutional and Statutory Texts*, 72 IOWA L. REV. 891 (1987).

45. See *infra* notes 263-64 and accompanying text.

46. See *infra* part IV.

be a test at all. In *Superintendent of Insurance v. Bankers Life & Casualty Co.*,⁴⁷ the United States Supreme Court unanimously held that the deception involved in that case was in connection with the purchase of securities involved. The defendants, managers of an insurance company, purchased the assets of the insurance company, which consisted of marketable bonds. Through a sophisticated series of transactions, the defendants paid for the bonds by borrowing against them. Thus, the insurance company was left without any assets and without compensation for the bonds it sold to the defendants, a fact that the defendants sought to hide through complex financing machinations.⁴⁸ The New York Superintendent of Insurance brought suit, claiming fraud in connection with the purchase of the bonds in violation of 10b-5.⁴⁹ The Supreme Court reversed the Second Circuit, holding that the complaint stated a cognizable claim under 10b-5.⁵⁰

It was not the facts or holding that caught the attention of lower courts. Rather, it was Justice Douglas's summary statement of the Court's rationale: "The crux of the present case is that [the insurance company] suffered an injury as a result of deceptive practices touching its sale of securities"⁵¹

The Court rejected by clear implication any suggestion that the "in connection with" requirement necessitated a showing that the deception relate to the value of the security being purchased.⁵² Although nothing suggests that such a showing was required before *Bankers Life*,⁵³ recent cases have followed the Supreme Court's lead in cutting back the expansion of 10b-5 by requiring such a showing.⁵⁴ The holding in *Bankers Life* is unremarkable, though, and the Court's unanimity is not surprising; the Court specifically found that the insurance company, an investor in the bonds, had been deceived by its management into believing that it would receive the proceeds from the bond sale.⁵⁵ This finding by the Court was suspect considering

47. 404 U.S. 6 (1971).

48. *Id.* at 7-9.

49. *Id.* at 7.

50. *Id.* at 13-14.

51. *Id.* at 12-13 (emphasis added).

52. See *Sargent v. Genesco, Inc.*, 492 F.2d 750, 763 (5th Cir. 1974).

53. The trial court listed four ways in which the "in connection with" requirement could be satisfied, only one of which had to do with deception regarding the value of the securities themselves. See *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 300 F. Supp. 1083, 1101 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971). The trial court correctly stated the law as it existed then. See also 5 A. JACOBS, *supra* note 4, § 117.01, at 5-71. The matter is now well settled. See, e.g., T. HAZEN, *supra* note 22, § 13.6, at 119 (Supp. 1988). "The 'in connection' with requirement is not limited to fraud relating to the merits of a particular security." *Id.*

54. See *infra* notes 315-19 and accompanying text.

55. *Bankers Life*, 404 U.S. at 9-10.

the contrary factual findings of the trial court.⁵⁶ But the Court's reading of the facts, even though suspect, makes the case a simple one in which a seller of securities was deceived by the buyer into parting with his securities for no consideration. This characterization seems to fit squarely within the terms of 10b-5.⁵⁷

In addition, the case represents a less expansive reading of the "in connection with" requirement than may be apparent. The Court reiterated the *Birnbaum* position⁵⁸ that 10b-5 does not reach complaints involving nothing more than internal corporate mismanagement.⁵⁹ The Court simply reaffirmed a common sense proposition—deception of an investor, inducing him into a securities transaction for the purpose of swindling him, is no less actionable under 10b-5 simply because the facts indicate corporate mismanagement.⁶⁰

C. *Touching in the Lower Courts*

Apparently overlooking the mundane holding in *Bankers Life* and its partial reaffirmation of the *Birnbaum* decision, lower courts have

56. The trial court had found that neither the trading process nor the investing public had been harmed, and that therefore the purposes behind section 10(b) would not be served by application in that case. See *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 300 F. Supp. 1083, 1101 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971). The Second Circuit specifically adopted that finding in its reasoning. See *Bankers Life*, 430 F.2d at 361.

57. The fact that an actual purchase and sale took place distinguishes *Bankers Life* from cases in which the securities are simply converted without any pretense of a purchase. In the latter case, the deception is generally held not to be in connection with any purchase or sale. See, e.g., *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986) (conversion does not bring federal law into play); *Bochicchio v. Smith Barney, Harris, Upham & Co.*, 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986) (conversion, even occurring from brokerage account, does not state a claim under 10b-5); *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1564-66 (E.D.N.Y. 1985) (no claim stated under 10b-5 where misrepresentation is limited to mechanics of sale rather than inducement to buy); cf. T. HAZEN, *supra* note 22, § 13.6, at 120 (Supp. 1988). "Thus, a conversion of securities will not support a 10b-5 claim without a showing that it was fraudulently induced." *Id.*

58. See *supra* notes 40-46 and accompanying text.

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

60. See, e.g., *Marshel v. AFW Fabric Corp.*, 533 F.2d 1277, 1282 (2d Cir.) (federal securities laws confer jurisdiction for instances of corporate mismanagement where fraud is intrinsic to securities transactions), *reh'g en banc denied*, 533 F.2d 1309 (2d Cir.), *vacated on other grounds*, 429 U.S. 881 (1976); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 379-80 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (assertions of corporate mismanagement will not cut off federal remedy); *Popkin v. Bishop*, 464 F.2d 714, 718 (2d Cir. 1972); *Herpich v. Wallace*, 430 F.2d 792, 808 (5th Cir. 1970) (corporate mismanagement does not immunize 10b-5 violations); *Rekant v. Desser*, 425 F.2d 872, 881 (5th Cir. 1970) (immaterial that violation is part of a larger scheme of corporate mismanagement). See generally *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539, 543-44 (N.D. Ill. 1970); *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 25 (S.D.N.Y. 1963).

seized upon the "touching" language from the opinion and have adopted it as the cornerstone for "in connection with" cases. Most commentators agree that the almost cavalier way in which the *Bankers Life* Court reached its holding indicates a shift toward a more expansive reading of the "in connection with" requirement than previously was given.⁶¹

Thus, many courts read the purported "touching" test as a de minimis requirement. For example, in *Sargent v. Genesco, Inc.*,⁶² the court stated that the *Bankers Life* case "establishes that the defendant's fraudulent conduct need not specifically relate to the plaintiff's securities transaction as in a misrepresentation involving the value of securities purchased or sold by the plaintiff. Instead, the requisite nexus exists if such conduct merely touches upon the plaintiff's purchase or sale."⁶³ *Sargent* is typical of many cases in which courts interpret the touching test broadly.⁶⁴ As a result, after *Bankers Life*, there was widespread agreement that the "in connection with" requirement was to be interpreted loosely.⁶⁵

The development of an early consensus of a broad touch test is curious, given that the concept of touching is neutral as to how close a nexus is required. Thus, it could be asserted that the "in connection with" requirement is satisfied because it requires only that the fraud and the sale of securities touch, or that the "in connection with" requirement is not satisfied because the fraud and the purchase or sale must actually touch. As the court pointed out in *Natowitz v. Mehlman*,⁶⁶ the touch test of *Bankers Life* is sufficiently ambiguous to be interpreted as broadly or narrowly as necessary to achieve a desired

61. See 5 A. JACOBS, *supra* note 4, § 117.01, at 5-72; L. SODERQUIST, *supra* note 6, at 253. "The looseness of the 'touching' formulation, and the almost summary way in which the Supreme Court disposed of the case, seemed to send a clear signal to lower courts that they were to continue to interpret Rule 10b-5 expansively." *Id.* See also A. JACOBS, *supra* note 4, § 38.01, at 2-45 (stating that *Bankers Life* "shows that Court's approval of a loose nexus between the fraud and the purchase and sale").

62. 492 F.2d 750 (5th Cir. 1974).

63. *Id.* at 763.

64. See, e.g., *Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975) (stating that touch test is "broad"); *Corbey v. Grace*, 605 F. Supp. 247, 252 (D. Minn. 1985) (asserting fraud "need only touch" the sale or purchase of securities); cf. *McGrath v. Zenith Radio Corp.*, 651 F.2d 458, 467 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981) (using touch test as rationale for interpreting "in connection with" requirement broadly).

65. See, e.g., *Buffo v. Graddick*, 742 F.2d 592, 596 (11th Cir. 1984); *Ketchum v. Green*, 557 F.2d 1022, 1026 (3d Cir.) (reporting trend), *cert. denied*, 434 U.S. 940 (1977); *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1315 (5th Cir. 1977), *reh'g denied*, 564 F.2d 416 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); T. HAZEN, *supra* note 22, § 13.6, at 470; L. SODERQUIST, *supra* note 6, at 253; *Recent Decision*, 46 GEO. WASH. L. REV. 482, 487 (1978) (discussing *Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977)).

66. 567 F. Supp. 942 (S.D.N.Y. 1983).

result.⁶⁷ To say that two things must touch gives no guidance.

More recent decisions recognize this fact and correctly note that the touching language from the *Bankers Life* opinion has been accorded too much importance: it was nothing more than Justice Douglas's literary style in restating the "in connection with" requirement and describing the outcome of the case.⁶⁸ With the touch test itself ambiguous,⁶⁹ courts suggest that the "in connection with" inquiry must be made on a case-by-case basis.⁷⁰ Presumably, they consider themselves free to judge the nexus in the case before them unrestrained by the touching language of *Bankers Life*.

These more recent cases represent a general trend recognizing there are limits to the extent 10b-5 can be used to remedy unlawful conduct tangentially involving securities transactions. To the extent *Bankers Life* calls for an expansive application of 10b-5, its historical context must be considered. This case was decided during the heyday of 10b-5, before Supreme Court cases of the mid-1970s limited the rule's expansion.⁷¹ As Jacobs points out: "The relatively narrow reading on policy grounds the Supreme Court gave in 1977 to the 10b-5 mismanagement cause of action permits lower courts, in close cases, to decide that the 'touching' test is not met."⁷² One commentator even suggests that more recent Supreme Court cases make the *Bank-*

67. *Id.* at 946.

68. See *In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986) (touch test nothing more than a restatement of the "in connection with" requirement); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984); *Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339, 361 (N.D. Ohio 1976); see also L. LOSS, *supra* note 10, at 903-04.

69. See *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 & n.18 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Natowitz v. Mehlman*, 567 F. Supp. 942, 946 (S.D.N.Y. 1983).

70. See *Buffo v. Graddick*, 742 F.2d 592, 596 (11th Cir. 1984); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 & n.18 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Natowitz v. Mehlman*, 567 F. Supp. 942, 946 (S.D.N.Y. 1983); see also 5 A. JACOBS, *supra* note 4, § 38.01[b], at 2-46 (suggesting case-by-case approach); Jacobs, *The Role of the Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27, 43 (1973) (suggesting case-by-case approach).

71. See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, *reh'g denied*, 425 U.S. 986 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, *reh'g denied*, 423 U.S. 884 (1975).

72. 5 A. JACOBS, *supra* note 4, § 117.01, at 5-73; see also L. SODERQUIST, *supra* note 6, at 253 (suggesting that the expansive interpretation of *Bankers Life* began to wane after *Blue Chip Stamps* and *Ernst & Ernst*, thus making later cases more important in analyzing the "in connection with" requirement, i.e., *Brown v. Ivie*, 661 F.2d 62 (5th Cir. 1981); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir. 1977)).

ers *Life* touch test of “dubious continuing vitality.”⁷³

In line with these Supreme Court cases, courts and commentators alike have begun to reject any suggestion that the “in connection with” requirement imposes merely a *de minimis* touching requirement.⁷⁴ One such case, *Blue Chip Stamps v. Manor Drug Stores*,⁷⁵ makes it clear that the “in connection with” requirement requires more touching than simply a light caress.

In *Blue Chip Stamps*, the defendant (a distributor of trading stamps) entered into an antitrust consent decree with the Justice Department. The terms of the consent decree required Blue Chip Stamps to offer stock in itself to retailers who were previous buyers of the stamps.⁷⁶ The retailer-plaintiffs, who had been offered stock in Blue Chip Stamps, allegedly declined to purchase because Blue Chip Stamps fraudulently and pessimistically misrepresented its financial condition.⁷⁷

The Supreme Court held that the complaint failed to state a claim under 10b-5, since the plaintiffs were not purchasers or sellers of securities.⁷⁸ The plaintiffs argued that the “in connection with” language of 10b-5 justified extending the rule to fraud in offers, which necessarily precede purchases or sales.⁷⁹ However, the Court rejected this expansive reading of the requirement.⁸⁰ There was an allegation of misrepresentation by Blue Chip Stamps and there was no question that Blue Chip Stamps sold securities. Nonetheless, the court found no 10b-5 violation. One reading of the case is that it rejected any *de minimis* touch test.

Although broad generalizations can be made concerning the expansion and subsequent contraction of the “in connection with” requirement over time, the most compelling feature of the case law is the resultant state of confusion. Courts simply have been unable to artic-

73. See Note, *The Pendulum Swings Farther*, *supra* note 8, at 67; see *supra* note 71 for three such cases.

74. See, e.g., *Head v. Head*, 759 F.2d 1172 (4th Cir. 1985):

The *Bankers Life* “*de minimis* touch test” might be read literally and expansively to make any securities transaction actionable under Rule 10b-5 so long as there was some deceptive practice remotely “touching” the transaction. But we think the test could not have been intended to be applied in so unlimited a way.

Id. at 1175 (citation omitted); see also *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942-43 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984) (stating that *Bankers Life* “pushed the perimeters [of the in connection with requirement] rather far”); T. HAZEN, *supra* note 22, § 13.6, at 120 (Supp. 1988) (*de minimis* touching no longer sufficient).

75. 421 U.S. 723, *reh'g denied*, 423 U.S. 884 (1975).

76. *Id.* at 725-26.

77. *Id.* at 726-27.

78. *Id.* at 727, 755.

79. *Id.* at 731.

80. *Id.* at 757 n.1 (Powell, J., concurring).

ulate principles for the interpretation and application of this requirement. The next two parts of this article attempt to remedy that deficiency.

IV. THE CROSS-CATEGORICAL USE OF THE "IN CONNECTION WITH" PRINCIPLES

One of the main causes of confusion when interpreting the "in connection with" requirement is the explosive growth of 10b-5 to cover vastly different types of transactions. As a result, the requirement also comes under analysis in a wide variety of situations.⁸¹ The doctrinally diffuse nature of 10b-5 makes it impossible to establish common principles for universal application of the "in connection with" requirement.

Nonetheless, courts seemingly have been unaware of the need for varied principles of interpretation and application in different cases. This section assembles a topical survey of six broad categories of cases in which "in connection with" problems have arisen, and describes the approaches taken by various courts in interpreting this requirement. The six categories are presented in roughly ascending order of tenuousness in the connection between the bad act involved and the resulting securities transaction. What becomes apparent is that courts struggle to apply standards of interpretation borrowed from factually dissimilar cases. Part V then attempts to dissipate the confusion by establishing principles of interpretation for the various types of cases.

A. Category 1: Paradigmatic Securities Fraud

The easiest category of cases to understand are those representing the paradigm of securities fraud. Congress undoubtedly contemplated those cases when it enacted section 10(b) of the 1934 Act.⁸² The paradigmatic case is that in which a seller of securities, for the purpose of inducing another to purchase those securities, deliberately and affirmatively misleads the buyer in a matter that would clearly

81. See 5 A. JACOBS, *supra* note 4, § 38.01, at 2-50 to 2-55 & nn.32-55 (listing 24 types of cases in which "in connection with" requirement has been found to be satisfied); see also *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 651 F.2d 615, 619 (9th Cir. 1981) ("in connection with" requirement satisfied in many situations outside of garden variety fraud).

82. The dearth of legislative history for section 10(b) and for rule 10b-5 is discussed *infra* notes 250-54 and accompanying text.

influence the buyer's investment decision.⁸³

1. The Principle of Greatest Possible Connection

Courts, not surprisingly, have had no trouble finding the fraud involved to be in connection with the sale of securities in such cases.⁸⁴ Also not surprising is the fact that courts make such findings without much explanation of the principles that lead them to that conclusion. Perhaps in the typical securities fraud case, the fraud and the purchase or sale are as closely connected as they can possibly be. Thus, when the case involves a situation in which one cannot imagine a closer connection between the fraud and the purchase or sale, the "in connection with" requirement is satisfied.

However, making such a statement is not particularly helpful (and indeed may beg the question), since it does not indicate *why* a connection exists at all in the paradigmatic case. A better description of what constitutes a "connection" is needed. Such a task is best accomplished by articulating principles that will differentiate those cases in which a connection exists from those in which one does not.

2. Causation Justifications

One court has justified a finding of connection in the paradigmatic securities fraud situation in terms of causation. In *Imperial Supply Co., Inc. v. Northern Ohio Bank*,⁸⁵ the court stated that "[the proper connection] is always present if it can be shown that the purchase or sale of a security was induced by a scheme or artifice to defraud"⁸⁶ In other words, the paradigmatic case involves the required

83. The paradigmatic case also encompasses the reverse transaction, in which a buyer misleads a seller in a similar manner. It was this reverse paradigm that motivated the drafting of 10b-5. See *Conference on Codification of the Federal Securities Laws: Summations*, 22 BUS. LAW. 793, 922 (1967) (statement of Mr. Milton Freeman).

84. See, e.g., *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 785-87 (2d Cir. 1951); *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228, 1236-38 (D. Del. 1978); *Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339, 362-63 (N.D. Ohio 1976); accord *Fleischer*, *supra* note 7, at 1292 (noting that 10b-5 clearly applies when a corporation disseminates misleading information for the purpose of selling or buying securities).

85. 430 F. Supp. 339 (N.D. Ohio 1976).

86. *Id.* at 362 n.14 (interpreting *Schlick v. Penn-Dixie Cement*, 507 F.2d 374 (2d Cir. 1974)). The case also presented the more complex question of the liability to a plaintiff who was a "forced seller" of securities in a tender offer. See *id.* at 362-63. The "forced seller" doctrine is a subset of the "purchaser/seller" requirement and states that an owner of securities who is forcibly cashed out in a merger transaction is a "seller" of securities even though the investor did not make an investment decision to sell in the transaction. See, e.g., *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 635 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967). That the plaintiff was a forced seller rather than a voluntary one does not change the "in connection with" analysis, however. The question simply becomes whether the misrepresentation was sufficiently connected with the merger that ultimately resulted in the plaintiff's being forced to sell. See *Imperial Supply*, 430 F. Supp. at 362-63.

connection because the defendant acted with scienter and thereby induced the plaintiff to enter into the transaction.

The same sort of explanation was given in a slightly different context in *Allen Organ Co. v. North American Rockwell Corp.*⁸⁷ In that case, the parties had entered into a contract whereby the defendant would provide the plaintiff with a license to manufacture artificial sound-generating devices.⁸⁸ In exchange, the plaintiff gave the defendant, among other things, securities issued by the plaintiff.⁸⁹ The plaintiff sued for breach of contract and violation of 10b-5 when the sound-generating devices allegedly failed to work as represented by the defendant.⁹⁰ The court treated the case as a simple example of misrepresentation by a securities buyer of the value of the consideration being paid. It dealt with the "in connection with" requirement as had the court in *Imperial Supply*⁹¹ by pointing out that, if the plaintiff's allegations were true, the misrepresentation caused the securities transaction to occur.⁹² "Thus, if the value of the goods to be exchanged has been misrepresented and has induced the transfer of stock in exchange therefor, the 'in connection with the purchase and sale of securities' requirement of Section 10(b) has clearly been satisfied."⁹³

As discussed in part V, there are several other principles that combine to justify finding the requisite connection in category 1 cases.⁹⁴ As will also be seen, the two principles discussed here—greatest possible connection and causation—which might explain the "in connection with" requirement in paradigmatic cases are of limited benefit in other categories. One category of cases in which notions of causation might be helpful is discussed in the next section.

87. 363 F. Supp. 1117 (E.D. Pa. 1973). The case is less a paradigm than that involved in *Imperial Supply* because in *Allen Organ Co. v. North Am. Rockwell Corp.*, 363 F. Supp. 1117 (E.D. Pa. 1973), the misrepresentation alleged was not as to the company issuing the securities but as to the consideration paid for the securities. *Id.* at 1125.

88. *Id.* at 1120.

89. *Id.*

90. *Id.* at 1120-21.

91. See *supra* notes 85-86 and accompanying text.

92. *Allen Organ*, 363 F. Supp. at 1128.

93. *Id.*

94. See *infra* notes 327-31 and accompanying text.

B. Category 2: Misrepresentation by Corporate Issuers Who Are Not Buyers or Sellers in the Transaction

An examination of category 1 cases illustrates the clear connection between the fraud and the securities transaction where the misrepresenter is also a buyer or seller. However, courts generally agree that the issuer may be liable in some cases even though the issuer is not a buyer or seller in the transaction that caused the plaintiff's harm.⁹⁵ This is simply an outgrowth of the general judicial rejection of the notion that the defendant must be in privity with the plaintiff or that the defendant must even be a buyer or seller at all.⁹⁶ Indeed, third parties such as accountants,⁹⁷ brokers,⁹⁸ and credit agencies may commit fraud in connection with the purchase or sale of securities, even when those third parties are not themselves trading in the securities.⁹⁹ As Professor Hazen has noted, "Any statement that is reasonably calculated to affect the investment decision of a reasonable investor will [be held to] satisfy the 'in connection with' requirement."¹⁰⁰

The factual situation of category 2 is fairly common: a corporation issues a statement about itself knowing it is false. Investors trade on the basis of that misrepresentation and ultimately lose money when the falsity of the representation comes to light. May those investors claim that the misrepresentation of the corporation was in connection with the investor's trades even if the corporation itself was not a purchaser or seller of securities? Certainly this connection is more attenuated than that in category 1. More than twenty years ago, Arthur Fleischer described the problem and the judicial response to that problem as it had developed up to that time:

The applicability of rule 10b-5 to corporate reports when the corporation has neither bought nor sold securities has been thought to raise special ques-

95. See, e.g., *SEC v. Savoy Indus.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *SEC v. Warner*, 652 F. Supp. 647, 650 (S.D. Fla. 1987); *Jaband, Inc. v. Four-Phase Sys., Inc.*, 631 F. Supp. 1339, 1343-44 (W.D. Wash. 1986); *SEC v. Penn Central Co.*, 450 F. Supp. 908, 913 (E.D. Pa. 1978); *Crofoot v. Sperry Rand Corp.*, 408 F. Supp. 1154, 1158-59 (E.D. Cal. 1976); see also T. HAZEN, *supra* note 22, § 13.6, at 470 (summarizing case law); Fleischer, *supra* note 7, at 1292-94.

96. See, e.g., *Sargent v. Genesco, Inc.*, 492 F.2d 750, 759-61 (5th Cir. 1974) (privity not required, although its presence may indicate the requisite connection).

97. The special treatment of accountants is discussed *infra* notes 144-69 and accompanying text.

98. The special treatment of brokers is discussed *infra* notes 118-43 and accompanying text.

99. See, e.g., *SEC v. Drysdale Sec. Corp.*, 785 F.2d 38, 40-41 (2d Cir. 1986); *Buffo v. Graddick*, 742 F.2d 592, 596-97 (11th Cir. 1984); *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1315 (5th Cir. 1977); *Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975); *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1566 (E.D.N.Y. 1985).

100. T. HAZEN, *supra* note 22, § 13.6, at 470.

tions. Rule 10b-5 speaks in terms of fraud in connection with the purchase or sale of any security. Early cases intimated that a defrauded person had a remedy only against the party from whom he bought, or to whom he sold, securities. However, this concept of "privity" has been rejected with increasing frequency by the courts in recent cases and it would appear to be sufficient for a cause of action under the rule that an investor bought or sold in reliance on a misleading statement made by a defendant.¹⁰¹

Not surprisingly, given the more attenuated nature of the connection in category 2 cases, the case law analysis is more problematic. In fact, in these third party liability cases, two distinct lines of analysis are drawn. The first approach holds that for the "in connection with" requirement to be satisfied, two critical elements must be shown: causation/materiality¹⁰² and intent on the part of the misrepresenter that the statement be relied upon by the investor in deciding to undertake the transaction. The other approach requires only causation/materiality. Thus, the former is a subjective standard; the latter is objective.

1. Causation/Materiality and Purpose/Intent

Professor Hazen's statement of the rule that courts apply in dealing with misrepresentations by non-trading corporations¹⁰³ is typical of many such cases. Many courts require in such cases, as a condition of finding the requisite connection, two distinct findings. First, the corporation must have "calculated" that the misrepresentation would be relied upon by investors. Second, the misrepresentation must have caused the transaction either to be consummated (if the action is by a private party) or to be of a type that would cause reasonable investors to consummate a transaction (if the action is an administrative or criminal enforcement action).¹⁰⁴

The latter requirement is nothing more than an offshoot of the analysis used in category 1 cases, with a special twist. In the category 1 cases, the connection might be found because the misrepresentation by one party to the transaction caused the other party to engage in the transaction. This idea is borrowed from non-trading corporation

101. Fleischer, *supra* note 7, at 1292-93. Fleischer went on to point out that the case law generally has required some showing that the company intended the investing public to rely on the misleading information. *Id.*

102. The close relationship between causation and materiality in this context is explored *infra* notes 105-06 and accompanying text.

103. See *supra* note 100 and accompanying text.

104. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); SEC v. Warner, 652 F. Supp. 647, 650 (S.D. Fla. 1987); Jabend, Inc. v. Four-Phase Sys., Inc., 631 F. Supp. 1339, 1343-44 (W.D. Wash. 1986); Crofoot v. Sperry Rand Corp., 408 F. Supp. 1154, 1158-59 (E.D. Cal. 1976).

misrepresentation cases. But where the plaintiff is not a victim of the misrepresentation (*i.e.*, where the action is an administrative or criminal enforcement action), courts have had to alter the causation rationale and have done so in the same way as in *Affiliated Ute Citizens v. United States*.¹⁰⁵ Thus, courts have altered the reliance requirement for face-to-face non-disclosure cases by speaking in terms of materiality.¹⁰⁶ To the extent that this causation/materiality requirement is what supports the connection in such cases, the category 2 analysis is meaningfully different from the category 1 analysis.

The requirement of intent (*i.e.*, that the misrepresenter's purpose is to cause the transaction) on the part of the misrepresenting corporation distinguishes category 2 analysis from category 1. Fleischer described this type of "in connection with" analysis in category 2 cases this way: "A company which knowingly releases a misleading report for dissemination to the general public would also appear to be liable under 10b-5 to those who rely on the information to their detriment, *at least where the reliance by the investing public is intended by the company.*"¹⁰⁷

Most instances in which a corporation disseminates misleading information probably involve cases in which the corporation does not intend that investors purchase or sell securities in reliance thereon. Yet corporations have important incentives to affect the markets in their securities by misleading the investing public. Thus, the question of intent by the corporation becomes a subjective inquiry of fact.¹⁰⁸

Corporations normally have reasons—and very proper ones—for desiring that the market place evaluate their securities in a fashion which they regard as sensible. These reasons may include the dominant interests of their stockholders in price performance of their stock, the desire to make options attractive to key employees, and the need to have a security adequately priced for possible acquisition purposes.¹⁰⁹

There may be other reasons as well. For example, the corporation may wish to keep the price of its stock depressed before the dissemination of good news to enable its insiders to buy large blocks of stock before the market reflects that news.

In *SEC v. Texas Gulf Sulphur*,¹¹⁰ the Second Circuit held that a company that intentionally disseminates false information after calculating that the investing public will enter into securities transactions in reliance thereon has committed a deception that is in

105. 406 U.S. 128 (1972).

106. *Id.* at 152-54.

107. Fleischer, *supra* note 7, at 1294 (emphasis added).

108. *Id.*

109. *Id.*

110. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

connection with the investors' purchases and sales.¹¹¹ The court stated: "[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 . . . if such assertions are false or are misleading or so incomplete as to mislead."¹¹² Thus, in cases in which a misleading statement was made without contemplation by the party disseminating the statement that the investing public rely thereon, even when the public might have actually relied on the misstatements, courts have held that the necessary connection between the deception and the purchase or sales is absent.¹¹³

The doctrinal progression from category 1 cases to category 2 cases in which courts require not only causation (or materiality) but subjective intent as well before finding the requisite nexus between the fraud and the purchase or sale is important to note. In moving from the end of the spectrum represented by category 1 cases, where the connection is facially clear, to category 2 cases in which the connection is less facially clear, these courts have added a new element to the "in connection with" inquiry—intent. In other words, a counterbalancing move is being made doctrinally: in losing the obvious connection of category 1 cases, rigor is gained in the "in connection with" inquiry.

2. Causation/Materiality Alone

Not all cases make a counterbalancing move. In failing to do so, they not only loosen the connection required, but they mistakenly assume that the simple causation rationale that supports the connection in category 1 cases¹¹⁴ can support the connection in category 2 cases as well.

For example, in *SEC v. Penn Central Co.*,¹¹⁵ the court explicitly rejected the subjective standard enunciated in *Texas Gulf Sulphur* in favor of a pure causation analysis: "We believe that the required nexus [between the fraud and the purchase or sale of securities] is most properly defined with reference to the concept of proximate

111. *Id.* at 862.

112. *Id.* The United States Supreme Court has approved, in dictum, this "causation/materiality plus intent" formulation. See *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 985 n.13 (1988).

113. See, e.g., *Jabend, Inc. v. Four-Phase Sys., Inc.*, 631 F. Supp. 1339, 1343-44 (W.D. Wash. 1986).

114. See *supra* notes 85-93 and accompanying text.

115. 450 F. Supp. 908 (E.D. Pa. 1978).

cause.”¹¹⁶ Other courts are less explicit in their rejection of the objective intent analysis but nonetheless state the inquiry as being whether it was reasonably foreseeable that investors would be caused to enter into a securities transaction.¹¹⁷

Missing from these cases is an explanation for the interpretation that the misrepresentation was in connection with the transaction. Although in the category 1 cases causation seems to be an adequate explanation, in category 2 cases causation alone is a less satisfying rationale for 10b-5 liability. The inadequacy of the causation rationale in category 2 cases may also indicate that causation alone is not the complete rationale for finding the required nexus in category 1. Perhaps category 1 cases are so compelling because of the confluence in such cases of clear causation and the principle of greatest possible connection. In category 2 cases, the principle of greatest possible connection does not operate.

The proper approach in these category 2 cases is discussed in part V. It is sufficient for present purposes to point out that the causation rationale that seemed adequate in category 1 cases seems less so in category 2 cases. Courts should not assume that inquiries that work in one type of case will work in others.

C. *Category 3: Third-Party Connections With the Purchase or Sale of Securities*

The third category of cases is related intimately to the second but raises somewhat different problems. The third category is made up of those cases in which the question is whether the securities transaction involved was in connection with the activities of third parties who were not buyers or seller of securities but whose deception af-

116. *Id.* at 913.

117. *See, e.g.*, SEC v. Savoy Indus., 587 F.2d 1149, 1171 (D.C. Cir. 1978) (“in connection with” requirement satisfied when “it may reasonably be expected that a publicly disseminated document will cause reasonable investors to buy or sell securities in reliance thereon”), *cert. denied*, 440 U.S. 913 (1979); SEC v. Warner, 652 F. Supp. 647, 650 (S.D. Fla. 1987) (10b-5 satisfied if it may reasonably be expected that a publicly disseminated document will cause reasonable investors to buy or sell in reliance thereon); *see also* Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (E.D. Pa. 1978):

[T]he “in connection with” requirement of Rule 10b-5 imposes in these cases the limitation that defendants can be liable for misrepresentations and omissions only if the defendants could reasonably foresee that these misstatements would be used in connection with the purchase or sale of a security.

Id. at 887 (footnote omitted); SEC v. Drysdale Sec. Corp., 785 F.2d 38, 40-41 (2d Cir. 1986) (where misrepresentations by third party were of a type ordinarily relied upon by investors, they were in connection with the sale of securities); Buffo v. Graddick, 742 F.2d 592, 596 (11th Cir. 1984) (one rationale for finding third party’s misrepresentations to be in connection with purchases of securities was causal connection between misrepresentations and the purchases); Bosio v. Norbay Sec., Inc., 599 F. Supp. 1563, 1566 (E.D.N.Y. 1985) (“in connection with” requirement requires using device of a sort that would cause reasonable investors to purchase or sell securities in reliance).

facts securities transactions. This category is similar to the category 2 cases in that the party whose potential liability is under scrutiny is not an actual buyer or seller of securities, but either makes statements affecting the transaction decision or is otherwise involved in the transaction. Category 3 cases raise special problems, however, because the defendant's connection with the transaction is of a different type and arguably more attenuated. This arguably greater degree of attenuation results from the fact that the defendant is not the issuer of the securities. In contrast, in category 2 cases, the party who actually makes the misrepresentation is affecting the purchase and/or sale of its own securities.

The greater degree of attenuation is only arguable; however, since a broker or accountant may have incentives similar to those of the issuing corporation in seeing the transactions go through at a favorable price. In addition, one might argue that a broker's involvement in a securities transaction is even greater than the issuer's, given the broker's actual execution of the trades. At any rate, we can say with confidence that the misrepresentations of a broker or accountant raise different problems from those encountered when the issuer makes the misrepresentation.

1. Brokers and the "In Connection With" Requirement

In examining cases that address whether the broker's action was in connection with the purchase or sale of securities, we find that the case law is in confusion. Sometimes there is almost no rationale given for a court's finding on the question. Where there is a rationale given, it often does not square with rationales given in similar cases. As with the category 2 cases, rationales are borrowed from other categories of cases without much apparent attention given to the dissimilarities in the cases.

Typical in this regard is *Landy v. FDIC*,¹¹⁸ in which the Third Circuit borrowed its rationale from the category 2 cases. The plaintiffs, investors in the securities of a bank, alleged that the bank president misappropriated approximately \$200,000 in bank funds and used the money to engage in illegal and unprofitable stock transactions. The losses from those transactions, the plaintiffs alleged, caused the bank to become insolvent and caused their bank securities to decline in value. Among the defendants named were the brokers who executed the unlawful stock trades for the bank president.

118. 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

The plaintiffs put forward two theories. First, they claimed that the \$200,000 worth of illegal purchases effectuated by the brokers amounted to fraud in connection with the purchase of securities. The court disposed of that argument by pointing out that the plaintiffs lacked standing to complain about those transactions since they were not purchasers or sellers in those transactions.¹¹⁹

The plaintiffs also argued that the brokers' unlawful acts were in connection with the plaintiffs' purchases of the bank's securities. As the court framed the inquiry: "The pertinent question here is whether the brokers' alleged acts were 'in connection with' plaintiffs' purchase of [bank] shares."¹²⁰ The court found that there was neither manipulation nor deception by the brokers that could be said to be in connection with the purchase of those shares. The plaintiffs' allegations were insufficient to support a manipulation claim, since the plaintiffs had not alleged a "scheme deliberately calculated to manipulate the market value" of the bank stock.¹²¹ The court then dealt with the possibility of deception in connection with the bank stock purchases by borrowing the analysis used in one subgroup of category 2 cases.¹²² "[A] scheme may be proscribed by rule 10b-5 if it includes misrepresentations which may reasonably be relied upon by the average investor in purchasing or selling the securities in question."¹²³ The court found the "in connection with" requirement unsatisfied under that standard without even questioning the applicability of the causation/materiality standard to the fact pattern before it¹²⁴—a fact pattern decidedly different from that involved in the category 2 cases whence that standard arose. A similar rationale was used in conjunction with several other rationales more recently in *Bosio v. Norbay Securities, Inc.*,¹²⁵ in which the plaintiff alleged that the defendant brokerage firm sold securities pursuant to the plaintiff's instructions but misappropriated the proceeds. The court offered no fewer than four rationales for its finding that the "in connection with" requirement was not satisfied. First, the court restated the causation/materiality rationale from the category 2 cases: "It is well established in this circuit that the 'in connection with' . . . requirement of 10(b) requires using a device 'of a sort that would cause reasonable investors to rely thereon, and [therefore] cause them to purchase or sell a corporation's securities.'"¹²⁶

119. *Id.* at 154-59.

120. *Id.* at 161.

121. *Id.*

122. See *supra* notes 95-117 and accompanying text.

123. *Landy*, 486 F.2d at 161 (citations omitted).

124. *Id.*

125. 599 F. Supp. 1563 (E.D.N.Y. 1985).

126. *Id.* at 1566 (citations omitted).

The court then offered three other rationales not seen in categories 1 and 2. Injecting a principle of temporal sequencing, the court noted that the requisite connection was missing where the fraud did not take place prior to or contemporaneously with the purchase or sale.¹²⁷ The court also suggested that misrepresentations concerning the "mechanics" of the sale (as opposed to misrepresentations concerning the securities themselves or the purpose for the sale) were not in connection with that sale.¹²⁸ Finally, the court suggested that section 10(b)'s purpose was merely to ensure the integrity of investor information, and that purpose was not impacted by the alleged misrepresentations concerning the broker's fidelity and competence.

This last rationale, stated without any survey of the legislative history of section 10(b),¹²⁹ is one that recurs in the case law and implies that a statute's application is limited by the scope of the principles that motivated it. The tenuous basis for this rationale is explored elsewhere.¹³⁰ The point here is merely that courts struggling with articulating principles for the application of the "in connection with" requirement put forth many possible rationales, generally without much explanation for the bases of those rationales.

The failure to articulate a compelling standard for application of the "in connection with" requirement has left the cases involving brokers' transactions in disarray. Some courts have joined with the *Bosio* court in suggesting that misrepresentations concerning the mechanics of a purchase or sale, as opposed to misrepresentations concerning the merits of a particular security, are not in connection with that purchase or sale.¹³¹ Implicit in such reasoning is the princi-

127. *Id.* This principle of temporal sequencing is one that recurs in the case law. See *infra* notes 299-304 and accompanying text. Although courts generally agree that any misrepresentation must come before the securities transaction to be in connection with it, there is no requirement that the transaction come immediately after the misrepresentation. See, e.g., *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 219 (S.D.N.Y. 1965).

128. *Id.*

129. As discussed *infra* notes 250-54 and accompanying text, there is scant legislative history to guide application of section 10(b), and there is nothing in the legislative history indicating that Congress was concerned solely with informational integrity.

130. See Fletcher, *Sophisticated Investors Under the Federal Securities Law*, 1988 DUKE L.J. 1081, 1139-40; Fletcher, *Principlist Models in the Analysis of Constitutional and Statutory Texts*, 72 IOWA L. REV. 891, 914-19 (1987).

131. See, e.g., *Saxe v. E. F. Hutton & Co.*, 789 F.2d 105, 108-09 (2d Cir. 1986) (allegation that plaintiff was induced by defendant to liquidate his stock account and invest in commodities did not state a claim under section 10(b), since plaintiff was never misled about the stocks he sold); *Nevitsky v. Manufacturers Hanover Brokerage Serv.*, 654 F. Supp. 116, 119 n.12 (S.D.N.Y. 1987). "A misrepresentation concerning the mechanics of a securities transaction, without particular regard to the nature of the securities them-

ple that only misrepresentations concerning the merits of a security will satisfy the "in connection with" requirement. Often that principle is stated explicitly.¹³²

Other courts in cases involving brokered transactions have either explicitly or implicitly rejected such a principle, often without clearly articulating any alternative principle.¹³³ In *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,¹³⁴ the Ninth Circuit held that a broker's failure to inform a customer about the risks of margin accounts constituted a misrepresentation in connection with the purchase and sale of securities.¹³⁵ As a rationale, the court merely noted that 10b-5 is to be read flexibly,¹³⁶ and that the fraud need only "touch" the securities transaction.¹³⁷

Some courts have also borrowed the causation rationale from categories 1 and 2. In *Angelastro v. Prudential-Bache Securities, Inc.*,¹³⁸ the Third Circuit rejected the principle that the misrepresentations must go to the merits of a security rather than to the mechanics of the process, by holding that misrepresentations concerning levels of margin interest were in connection with the purchase of securities.¹³⁹ The court explained that the touching requirement of *Bankers Life*

selves, is not actionable under section 10(b)." *Id.*; cf. T. HAZEN, *supra* note 22, § 13.6, at 120 (1985 & Supp. 1988) (not sufficient that alleged fraud in connection with commodities investments led plaintiff to liquidate securities holdings).

132. *See, e.g.*, *Saxe v. E. F. Hutton & Co.*, 789 F.2d 105, 108-09 (2d Cir. 1986) (plaintiff's allegation that broker induced him, through misrepresentations, to liquidate his stock portfolio and invest in commodities was not sufficient given the "in connection with" requirement, since there was no allegation of misrepresentations concerning the stocks that were sold); *Bohicchio v. Smith Barney, Harris, Upham & Co.*, 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986) (theft by broker of customer's securities sales proceeds not fraud in connection with sale of the securities, since there was no misrepresentation concerning any of the securities involved); *Crummere v. Smith Barney, Harris, Upham & Co.*, 624 F. Supp. 751, 755 (S.D.N.Y. 1985) (deception that does not relate to specific securities is not in connection with their purchase or sale).

133. Rejection of the principle does not always work against the broker. In the seminal case of *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967), a broker was suing a customer who allegedly placed an order for the purchase of securities intending to pay for them only if they increased in value. The court held that such allegations stated a claim under 10b-5, rejecting the suggestion of the defendant that 10b-5 could only be used when the alleged fraud concerned the investment value of the securities. *Id.* at 396-97.

134. 651 F.2d 615 (9th Cir. 1981).

135. *Id.* at 619.

136. *Id.* More thoughtful analysis has led some courts to conclude that the oft-repeated suggestion that 10b-5 is to be read flexibly, not restrictively, to protect investors offers no real guidance. *See, e.g.*, *DMI Furniture, Inc. v. Brown, Kraft & Co.*, 644 F. Supp. 1517, 1528 (C.D. Cal. 1986).

137. *Arrington*, 651 F.2d at 619; *see also Corbey v. Grace*, 605 F. Supp. 247, 252 (D. Minn. 1985) (allegation of misstatements made by broker to entice customer to open brokerage account, leading to purchases of securities for that account, stated claim under 10b-5, since the misrepresentations need only "touch" the purchase or sale of securities).

138. 764 F.2d 939 (3d Cir.), *cert. denied*, 106 S. Ct. 267 (1985).

139. *Id.* at 941-44.

requires only some causal connection between the fraud and the purchase or sale.¹⁴⁰

Importantly, however, the court failed to note the differences between the case before it and those category 1 and 2 cases in which causation plays so central a role in giving life to the "in connection with" requirement. In both category 1 and category 2 cases, the causation is always supplemented by the fact that any misrepresentations go to the merits of the security being traded. The court's exclusive reliance on causation is made even more curious by its explicit statement that 10b-5's purpose is to ensure the informational integrity of investment decisions;¹⁴¹ a statement generally made by courts in support of restricting the "in connection with" requirement to cases in which the misrepresentations go to the merits of the securities purchase.¹⁴²

These broker transaction cases amply illustrate the confusion surrounding application of the "in connection with" requirement. One senses in reading cases such as these, that the courts are "eyeballing" the alleged fraud and the purchase or sale of securities and simply assessing the degree to which there seems to be a closeness, nexus, or a connection between the two. The rationales do not appear to be steps in a reasoning process or tests that can be applied syllogistically; rather, they seem to be post facto explanations for findings the judges are unable to explain in any other way. The "eyeballing" assessment of transactional proximity may itself be a standard by which the requisite connection between the fraud and the transaction may be judged. Perhaps it is even an appropriate one, given the lack of guidance provided by section 10(b) and rule 10b-5.¹⁴³ Nonetheless, if that is what is occurring, the courts should confront that fact and address the method's legitimacy.

2. Misrepresentations by Accountants

Cases involving misrepresentations by accountants arguably involve an even greater attenuation between the fraud and the purchase or sale of securities than that found in the broker cases,

140. *Id.* at 943.

141. *Id.* at 942.

142. In fact, the case cited by the court in support of its informational integrity statement was *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), in which the informational problem (non-disclosure of material facts) concerned matters that went to the value of the securities being sold.

143. The appropriateness of this form of inquiry is discussed *infra* note 314 and accompanying text.

since accountants do not actually effectuate transactions. However, under proper circumstances they, too, have been held to act in connection with a shareholder's securities transaction if they utter misrepresentations. The unifying feature of the cases in which liability is found is a rejection of the principle that any misrepresentation must concern the merits of a given security. The existence of unifying features should not be exaggerated; the case law is in disarray, both in the courts' willingness to subject accountants (acting in normal accountants' roles) to liability under 10b-5 and in the courts' enunciation of principles for distinguishing cases in which the requirement is satisfied from those in which it is not. The disarray in the case law is amply demonstrated by an examination of the opinions in three Second Circuit cases.

One panel in a 1986 case, *SEC v. Drysdale Securities Corp.*,¹⁴⁴ simply borrowed the causation/materiality principle, holding that if an accountant makes a misrepresentation of a type that reasonable investors are foreseeably likely to rely upon, that misrepresentation is in connection with the investor's securities transaction.¹⁴⁵ Cases such as this are curious in their borrowing of the category 2 rationale. The accountant's role as a non-trading speaker is similar to that of the non-trading corporate issuer involved in category 2, but the former's role is more attenuated than the latter's, since the alleged misrepresentations made by an accountant do not necessarily go to the merits of the securities and the accountant does not have the issuer/security nexus present in the category 2 cases. Nonetheless, the accountant cases just cited¹⁴⁶ do not even impose the intent requirement many category 2 cases impose. Thus, an odd situation arises in which the connection appears more attenuated, but the stringency of the "in connection with" inquiry is actually lessened.

Another panel of the same court solved the anomaly in 1975 by adopting the more stringent category 2 principle for application of the "in connection with" requirement: the necessity of finding both causation/materiality and intent by the defendant.¹⁴⁷ In *Competitive*

144. 785 F.2d 38 (2d Cir. 1986).

145. *Id.* at 40-41 (where accountant fraudulently misrepresented the financial condition of "repo" lender, such misrepresentation was in connection with the purchase of repo contracts since that financial condition is something repo purchasers rely upon). See also *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879 (E.D. Pa. 1978):

[T]he "in connection with" requirement of Rule 10b-5 imposes in these cases the limitation that defendants can be liable for misrepresentations and omissions only if the defendants reasonably could foresee that these misstatements would be used in connection with the purchase or sale of a security.

Id. at 887 (footnote omitted) (denying judgment *non obstante veredicto* for defendant accounting firm).

146. See *supra* note 145.

147. See *supra* notes 103-13 and accompanying text.

Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath,¹⁴⁸ the plaintiff alleged that the defendant accounting firm intentionally misstated a financial advisor's finances in an attempt to induce the plaintiff to allow the advisor to purchase and sell securities for him—purchases and sales the plaintiff claimed were manipulative. In affirming the denial of summary judgment for the defendant, the panel first noted that the "touch" test of *Bankers Life* was a very broad one.¹⁴⁹ It then based its decision that the "in connection with" requirement was satisfied on the fact that the plaintiff had alleged actual intent on the part of the defendant to induce the plaintiff to rely on the alleged misrepresentations in making the investment decision.¹⁵⁰ The panel implicitly rejected the notion that the misrepresentation must concern the securities being purchased or sold.

In 1984, a third panel of the same court adopted the principle implicitly rejected by the *Competitive Associates* panel. In *Chemical Bank v. Arthur Andersen & Co.*,¹⁵¹ the defendant accounting firm allegedly made a knowingly false audit of the financial statements of the Frigitemp Corporation. The plaintiff banks alleged that they relied on those financial statements in making substantial loans to Frigitemp that were secured in part by a pledge of securities of a Frigitemp subsidiary.¹⁵² Since the Second Circuit had already held pledges of stock to be "sales" within the meaning of the antifraud provisions of the federal securities laws,¹⁵³ the court was faced squarely with the question whether the alleged misrepresentations by the accounting firm in its audit were in connection with the "sales" of the subsidiary's stock. The panel, in an opinion by Judge Henry Friendly, held they were not.

Judge Friendly first rejected the contention that the touching language of *Bankers Life* was the standard for satisfying the "in connection with" requirement. Instead, wrote Friendly, the phrase was just the literary style of Justice Douglas and carried no content.¹⁵⁴ In fact, Judge Friendly went so far as to opine that the *Bankers Life* decision had pushed the parameters of the "in connection with" requirement rather far, implicitly suggesting that later Supreme Court

148. 516 F.2d 811 (2d Cir. 1975).

149. *Id.* at 815.

150. *Id.*

151. 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984).

152. *Id.* at 941.

153. *See Mallis v. FDIC*, 568 F.2d 824, 829 (2d Cir.), *cert. granted*, 431 U.S. 928 (1977), *cert. dismissed*, 435 U.S. 381 (1978).

154. *Chemical Bank*, 726 F.2d at 943.

case law limiting 10b-5's expansion called the viability of *Bankers Life* into question.¹⁵⁵ Most importantly, however, the 1984 panel of the Second Circuit did what the 1986 and 1975 panels were unwilling to do in similar cases: the panel held that the "in connection with" requirement is only satisfied where the misrepresentations pertain to the securities themselves:

The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.¹⁵⁶

In the case before it, the panel found that the plaintiff banks received precisely what they expected to receive in the pledge: the securities of a company about which the defendant accounting firm had made no representation.¹⁵⁷ In fact, Judge Friendly explicitly rejected any weak form of causation as a sufficient principle for satisfaction of the "in connection with" requirement. "But for" causation is not enough, the panel decided, and "it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of securities is a part."¹⁵⁸ The panel enunciated what may be termed a principle of incidentality that arises in many cases: The pledge of stock "was merely an incident in a transaction not otherwise involving the purchase or sale of securities."¹⁵⁹

Thus, in looking at the three Second Circuit decisions, an odd mélange of principles is enunciated for application of the "in connection with" requirement, some directly at odds with others:

Drysdale Securities (1986):

- * Causation, in the form of reliance, sufficient.

Competitive Associates (1975):

- * Causation, in the form of reasonable foreseeability of the reliance, insufficient unless defendant intended that reliance.
- * Touch test of *Bankers Life* very broad.

Chemical Bank (1984):

- * Touch test of *Bankers Life* substanceless; pushed parameters of "in connection with" requirement rather far.
- * Mere causation in fact insufficient.
- * Misrepresentations must pertain to the securities themselves.
- * Incidental association of misrepresentation and purchase or sale of securities in the same transaction insufficient.

Of course, the confusion is not limited to the Second Circuit. The

155. *See id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* at 944 n.24.

case law involving the "in connection with" requirement and non-trading accountants evidences a generalized disarray with respect to guiding principles for the application of the requirement. A lack of causal relationship between the fraud and purchase or sale has been held in many such cases to defeat a claim that the "in connection with" requirement was satisfied.¹⁶⁰ In at least one of those cases, the lack of causation was explained in terms of the principle of temporal sequencing discussed above:¹⁶¹ where the misrepresentation came after the transaction, the misrepresentation is not in connection with that transaction.¹⁶² Several courts in the accountant context have agreed with Judge Friendly's limiting principle that just because a transaction includes both fraud and a purchase or sale of securities does not mean that the fraud was in connection with that purchase or sale.¹⁶³

In *In re Financial Corp. of America Shareholder Litigation*,¹⁶⁴ the Ninth Circuit came close to adopting the *Chemical Bank* holding that the misrepresentation must concern the securities bought or sold by the plaintiff. The court found no requisite nexus since the accountant's statements had nothing to do with the intrinsic value of the securities, the risks involved in them, or any other factor "reasonably linked" to the plaintiff's loss.¹⁶⁵

Another principle that arises more often in other categories also finds its way into the accountant cases as well. This principle, which may be termed a principle of exclusive alternatives, states that where the fraud is in connection with something other than the purchase or sale of securities, that fraud may not also be in connection with the securities transaction. In *Rich v. Touche Ross & Co.*,¹⁶⁶ the plaintiff was a customer of a brokerage firm that became insolvent, resulting in losses to the plaintiff. The plaintiff sued the auditor of the brokerage firm, alleging that but for the misrepresentations and omissions of the auditor, the plaintiff would not have purchased securities through the broker. The court inquired into whether the alleged

160. See, e.g., *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 650 (9th Cir. 1988); *In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 98 (S.D.N.Y. 1976).

161. See *supra* notes 127-28 and accompanying text.

162. See *Roberts*, 857 F.2d at 652.

163. See, e.g., *In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986); *DMI Furniture, Inc. v. Brown, Kraft & Co.*, 644 F. Supp. 1517, 1528 (C.D. Cal. 1986).

164. 796 F.2d 1126 (9th Cir. 1986).

165. *Id.* at 1130.

166. 415 F. Supp. 95 (S.D.N.Y. 1976).

fraud was “so proximately related either to a purchase or a sale, as to be actionable as ‘in connection with’ such a transaction.”¹⁶⁷ In finding that the proximate relation was absent, the court applied a principle of exclusive alternatives: “The alleged misrepresentations and omissions were not made in connection with any purchase of securities, but rather, in connection with a bailment.”¹⁶⁸ The court did not explain why fraud could not be in connection with both the purchase and the bailment. This principle of exclusive alternatives is explored in more detail below.¹⁶⁹

3. Misrepresentations by Other Third-Party Non-Traders

This category of cases is not limited to brokers and accountants. Indeed, the problems are similar whenever a third-party who is not a trader of securities makes misrepresentations that affect the investment decision of people who do trade securities. For example, in *Crofoot v. Sperry Rand Corp.*,¹⁷⁰ a corporation was formed and sought computer hardware from the defendant. Before the corporation sold its stock to the initial subscribers, the defendant allegedly made assurances concerning the usefulness of its hardware. When those assurances turned out to be false, the investors sued under 10b-5, claiming the assurances were in connection with their purchase of the corporation’s stock. The court rejected the defendant’s motion to dismiss, finding the “in connection with” requirement satisfied, since the assurances were allegedly made in a manner calculated to influence the plaintiffs’ investment decision.¹⁷¹

A similar analysis was made in *Jabend, Inc. v. Four-Phase Systems, Inc.*,¹⁷² where on similar facts, the court found the “in connection with” requirement unsatisfied. The individual plaintiff organized a computer company and caused the plaintiff corporation to issue him stock. The plaintiffs alleged that the corporation was formed based on misrepresentations of the defendant that the defendant could supply computer equipment capable of making the plaintiff’s corporation feasible. The equipment turned out to be unusable, and the plaintiffs sued under 10b-5. The court found the “in connection with” requirement unsatisfied because the plaintiffs failed to show that the alleged fraud in the sale of the computer equipment was calculated to influence the sale of stock by the corporation.¹⁷³ Specifi-

167. *Id.* at 98.

168. *Id.* at 99; *cf. In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130-31 (9th Cir. 1986) (loss that resulted from SEC accounting ruling could not also have resulted from defendant’s fraud).

169. See *infra* note 273 and accompanying text.

170. 408 F. Supp. 1154 (E.D. Cal. 1976).

171. *Id.* at 1158-59.

172. 631 F. Supp. 1339, 1343-44 (W.D. Wash. 1986).

173. *Id.* at 1343.

cally, the court stated:

There is no direct connection between Four-Phase's alleged misrepresentations and Großenick's purchase of Jabend stock. Even assuming that Four-Phase meant to defraud Jabend in the sale of its computers, Großenick has not shown that such fraud was an overall scheme to defraud purchasers of Jabend stock. . . . Four-Phase had nothing to gain from Jabend's sale of common stock.¹⁷⁴

The disarray in the cases is evident. The courts use nearly a dozen principles, in various combinations, in an attempt to justify application of the "in connection with" requirement to specific fact patterns. Many of these principles are passed from category to category without any inquiry as to their applicability as the fact patterns change in their levels of attenuation between fraud and transaction.

D. Category 4: Corporate Mismanagement Cases

A category of cases in which the focus is less on causation than in the first three, but which contains many conceptual similarities to the category 2 and category 3 cases, is that involving application of 10b-5 to instances of corporate mismanagement. This particularly vexing set of cases exists in a vise between two accepted principles. The first is that the federal securities laws generally, and 10b-5 specifically, are not to be used as mechanisms for complaining about ordinary corporate mismanagement.¹⁷⁵ The second is that 10b-5 is applicable even if the 10b-5 violation also happens to be a breach of fiduciary duty by managers.¹⁷⁶

The mismanagement cases have some similarity to the category 2 cases as the complaint is typically leveled by a shareholder at his own corporation or its management. They are also similar to the broker cases of category 3 as they involve the breach of an implicit promise to perform faithfully.¹⁷⁷ The case law in this area is also in a state of

174. *Id.*

175. *See, e.g.,* Santa Fe Indus. v. Green, 430 U.S. 462, 477-80 (1977); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

176. *See, e.g.,* Marshel v. AFW Fabric Corp., 533 F.2d 1277, 1282 (2d Cir.), *reh'g en banc denied*, 533 F.2d 1309 (2d Cir.), *vacated on other grounds*, 429 U.S. 881 (1976); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 379-80 (2d Cir. 1974); Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972); Herpich v. Wallace, 430 F.2d 792, 808 (5th Cir. 1970); Rekant v. Dresser, 425 F.2d 872, 882 (5th Cir. 1970); Bailey v. Meister Brau, Inc., 320 F. Supp. 539, 543-44 (N.D. Ill. 1970); Pettit v. American Stock Exch., 217 F. Supp. 21, 25 (S.D.N.Y. 1963).

177. Courts generally recognize that a mere breach of the implicit representation to perform one's fiduciary duties faithfully will not give rise to a 10b-5 action. *See, e.g.,* Pross v. Katz, 784 F.2d 455, 458 (2d Cir. 1986). Indeed that principle is clearly implicit

confusion as a result of the courts' inability to reach a consensus on the proper principles for interpretation and application of the "in connection with" requirement. The mismanagement cases are of two primary types: those involving sales by a corporation of securities for inadequate consideration, and those involving internal power struggles.

1. Sales for Inadequate Consideration

Because the *Bankers Life*¹⁷⁸ case involved an allegation that the corporation was duped into selling securities through a misrepresentation that the corporation would receive the consideration for the sale, and because that case held that such an allegation stated a claim under 10b-5, subsequent cases involving similar facts have reached the same conclusions without much discussion.¹⁷⁹ However, *Bankers Life* leaves no discernible principle (aside from the "touching" statement of Justice Douglas) for *why* such a misrepresentation is deemed to be in connection with the sale of securities. Such principles are developed more fully in pre-*Bankers Life* cases.

The year before *Bankers Life* was decided, the Fifth Circuit held in *Rekant v. Dresser*,¹⁸⁰ that where officers or directors cause the corporation to sell stock to them for grossly inadequate consideration, the corporation has a 10b-5 action against them, even where the same acts would result in liability under state fiduciary duty principles.¹⁸¹ The rationale offered by the court is curious: such a case is not significantly different from one in which one person perpetrates securities fraud on another.¹⁸² One might agree that, by analogy, such a case should be treated the same as a category 1 case, but the attenuation between the fraud and the transaction is clearly greater. In fact, one might also analogize such a case to those cases in which one party simply steals securities from another. The only difference is that a conversion involves *no* consideration, whereas *Rekant* involved grossly inadequate consideration. Such a conversion of stock is generally thought to not give rise to a 10b-5 action.¹⁸³

in the Supreme Court's decision in *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), in which the Court held that corporate mismanagement involving full and complete disclosure does not give rise to a 10b-5 claim.

178. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

179. *See, e.g., Jannes v. Microwave Communications, Inc.*, 461 F.2d 525 (7th Cir. 1972). *See also SEC v. Fifth Ave. Coach Lines, Inc.*, 435 F.2d 510, 517 (2d Cir. 1970) (pre-*Bankers Life* case finding, without meaningful discussion, no error in granting an SEC injunction under 10b-5 where corporate officers sought to sell stock to another corporation knowing that the latter could not pay for it).

180. 425 F.2d 872 (5th Cir. 1970).

181. *Id.* at 882.

182. *Id.*

183. *See, e.g., Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986); *Bochicchio v. Smith Barney, Harris, Upham & Co.*, 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986); *Bosio v. Norbay*

The point is not that the case was wrongly decided. Indeed, as suggested above, *Bankers Life* was an unextraordinary case given the Court's finding that the corporation/seller was duped into believing it would receive consideration for the securities sold. Rather, the point is that in *Rekant* the rationale was insufficiently articulated.

A much more satisfying attempt to explain the "in connection with" requirement came in *Bailey v. Meister Brau, Inc.*,¹⁸⁴ in which the plaintiff alleged on behalf of the corporation that the corporation had been duped by its directors into selling nearly \$2 million worth of stock to the defendant for approximately \$440,000. The court refused to dismiss the case, and in the course of its decision introduced a principle that segregates those cases in which the securities transaction is merely incidental to the fraud from those in which the transaction is an essential feature of the scheme. "[T]here must be a determination," wrote the court, "of the degree to which the securities transactions were incidental to the fraud."¹⁸⁵

In doing so, the court distinguished those cases in which the securities transaction came after the fact as an incidental means, for example, of obscuring the fraud that had already occurred:

In the instant case, however else the parties may have accomplished their goals, they chose in fact to trade securities. The form of the transaction necessarily brought into being a buyer and a seller of securities. A transfer of securities ensued. This securities transaction was not merely incidental to the transaction but was the heart of it. It was not designed in any way to disguise or obscure the transfer and, finally, it is alleged to be the gist of the purported conspiracy to deceive and defraud. It was, therefore, a sale of securities of such a nature as to come within the ambit of the federal securities laws.¹⁸⁶

Of course, the court did not explain how to determine whether the securities transaction was incidental or essential to the fraud, but at least the court articulated a principle for application of the "in connection with" requirement. This incidental/essential distinction is one that recurs in the case law.¹⁸⁷

2. Intracorporate Power Struggles

Indeed, the distinction drawn by the court in *Bailey* between incidental and essential transactions was used, along with two other prin-

Sec., Inc., 599 F. Supp. 1563, 1564-66 (E.D.N.Y. 1985); cf. T. HAZEN, *supra* note 22, § 13.6, at 120 (1985 & Supp. 1988). "Thus, a conversion of securities will not support a 10b-5 claim without a showing that it was fraudulently induced." *Id.*

184. 320 F. Supp. 539 (N.D. Ill. 1970).

185. *Id.* at 543.

186. *Id.* at 543-44.

187. See *infra* note 305 and accompanying text.

ciples for application of the “in connection with” requirement, by the Fourth Circuit in *Taylor v. First Union Corp. of South Carolina*.¹⁸⁸ The plaintiff’s husband had been a director of a bank holding company (the Southern Company), in which the plaintiff held stock. The plaintiff sold her stock to the defendant, First Union, at \$18 per share shortly before First Union merged with the Southern Company at \$33 per share. Not long after that, plaintiff’s husband was pressured into resigning, and he alleged that he was lied to in the course of the termination. In the action, the plaintiff sought relief under 10b-5, arguing that the lies made to her husband were in connection with the sale of stock shortly before the merger.¹⁸⁹

In reversing a jury verdict in favor of the plaintiff, the court ruled that the alleged lies were not in connection with the sale of stock for three reasons. First, the court reiterated the incidental/essential distinction made in *Bailey*. It found the misrepresentations to have concerned his employment, not the sale of the stock. The plaintiff had argued that the stock sale was all part of a larger fraudulent scheme, but the court disagreed: “The alleged acts of deception here most directly involve circumstances of that termination and are only *tangentially and incidentally* related to the sale of plaintiff’s stock.”¹⁹⁰

Second, the court stated the principle of exclusive alternatives: “[A]ny misrepresentations concerning the purpose of the meeting at which Taylor was terminated were plainly not in connection with the stock sale, but rather, were in connection with the discharge.”¹⁹¹ The court made it clear that the policies of the securities laws are not furthered by applying 10b-5 whenever there is wrongdoing and a sale of stock happens to take place.¹⁹²

Finally, the court seemed to suggest that any misrepresentation would have to relate to the merits of the security being sold, echoing the holding of Judge Friendly in the *Chemical Bank* case:¹⁹³ “The plaintiff was not misled in her investment decision by the non-disclosure of material information nor was she deceived about the value of the stock or the potential value of the company. Thus, the requisite nexus between the sale and any fraud or deception is simply lacking.”¹⁹⁴

The approach taken by the Fourth Circuit in *Taylor*—presenting numerous possible rationales for a given application of the “in connection with” requirement—is as typical in category 4 cases as it is in

188. 857 F.2d 240 (4th Cir. 1988).

189. *Id.* at 242.

190. *Id.* at 245 (emphasis added).

191. *Id.*

192. *Id.* at 247.

193. See *supra* notes 151-59 and accompanying text.

194. *Taylor*, 857 F.2d at 246.

other categories. The incidental/essential distinction, for example, finds its way into many of these cases,¹⁹⁵ often combined with other principles, such as causation¹⁹⁶ or temporal sequencing.¹⁹⁷ Even the principle of exclusive alternatives has found expression in this type of case.¹⁹⁸ Other courts have been much less forthcoming in explaining why an intracorporate power struggle with a securities transaction does or does not involve fraud in connection with such a transaction. Often, courts dismiss a case involving an intracorporate power struggle by reciting the maxim that not every breach of fiduciary duty is a 10b-5 violation, and 10b-5 should not be used to remedy mere breaches of such a duty.¹⁹⁹

Without doubt, however, the most doctrinally rich opinion concerning the "in connection with" requirement in the power struggle context came from the Third Circuit in *Ketchum v. Green*.²⁰⁰ In that seminal case, the plaintiffs were officers and directors of a corporation who controlled a majority of the stock of that corporation. There was an agreement in effect that stipulated that any officer whose employment was terminated was required to sell his stock back to the corporation for a calculated sum. The defendants, other directors, allegedly planned a scheme whereby the board would approve a slate of directors, a majority of whom were hostile to the plaintiffs and whose hostility was concealed from the plaintiffs. As soon as the new board was elected (plaintiffs naively voting their majority of shares in favor of the slate), the board voted to terminate

195. See, e.g., *Marshall v. AFW Fabric Corp.*, 533 F.2d 1277, 1282 (2d Cir.) (allegation of freeze-out without business purpose states claim under 10b-5, where "a purchase and sale of securities is at the heart of the fraudulent scheme"), *reh'g en banc denied*, 533 F.2d 1309 (2d Cir.), *vacated*, 429 U.S. 881 (1976).

196. See, e.g., *Hunt v. Robinson*, 852 F.2d 786, 786-88 (4th Cir. 1988) (allegation that defendants agreed as part of employment contract with plaintiff to give him stock and then reneged was insufficient under 10b-5 even if contract is deemed a "sale," since the gravamen of the complaint was failure to convey stock and since there was no causal link between the misrepresentation and the sale).

197. See, e.g., *Lester v. Preco Indus.*, 282 F. Supp. 459, 462 (S.D.N.Y. 1965) (allegation that defendants sold stock to public and then mismanaged company, causing decline in share value, did not state claim under 10b-5, since sale of stock was incidental to any wrongdoing and any misrepresentations occurred after sales).

198. See, e.g., *Vincent v. Moench*, 473 F.2d 430, 435 (10th Cir. 1973) (where injury results from corporate mismanagement rather than from purchase or sale of securities, any fraud is not in connection with that purchase or sale).

199. See, e.g., *Kaminsky v. Abrams*, 281 F. Supp. 501, 504 (S.D.N.Y. 1968); see also *Buffo v. Graddick*, 742 F.2d 592, 596 (11th Cir. 1984) (one factor to consider in applying "in connection with" requirement is whether the transaction involved little more than corporate mismanagement).

200. 557 F.2d 1022 (3d Cir.), *cert. denied*, 435 U.S. 940 (1977).

the plaintiffs and to force them to sell their stock back to the corporation. The plaintiffs sued under 10b-5 claiming the deception concerning the mechanism of ouster was in connection with the forced sale of their securities.²⁰¹ The Third Circuit accepted the claim that there was deception involved;²⁰² there was no doubt that the plaintiffs were being forced to sell securities. Nonetheless, the court found that the deception was not in connection with that sale,²⁰³ and in the course of the opinion the court touched on no fewer than six principles for application of the “in connection with” requirement.

First, the court discussed the degree to which the stock sale was merely incidental to the deception. After noting that cases following *Bankers Life* had tended to require only a tangential relationship between the fraud and the transaction, the court noted that in the case before it the “thrust” of the complaint was not the stock sale but the plaintiffs’ ouster.²⁰⁴ Thus, the stock sale was a mere “consequence” of the deception.²⁰⁵

Second, the court made a statement of the exclusive alternatives principle. It reasoned that the fraud occurred not in connection with the stock sale: “To the contrary, the purportedly deceptive practices occurred . . . in connection with the struggle for control of the corporation.”²⁰⁶

Third, the court discussed the “in connection with” requirement in terms of transactional proximity:

The Supreme Court’s opinion in *Bankers Life* does not reveal how close a nexus must exist between a misrepresentation and a transaction. Nonetheless, it is quite evident that there was a fairly tight linkage between these elements in the *Bankers Life* setting: the theft of the consideration flowing from the sale of the bonds was only one step removed from the bond transaction itself.²⁰⁷

In the case before it, the court found many intervening steps between the fraud and the sale of the stock, leading to its conclusion that the fraud and the sale were not tied together sufficiently.²⁰⁸ In the court’s view, then, there must be a “tight linkage” between the deception and the transaction; the degree of linkage is determined at least in part, by examining the directness with which the transaction follows the deception.

Fourth, the Third Circuit argued that the directness of linkage is not exactly a matter of causation. Both causation and the “in connection with” requirement have to do with proximity, and they are con-

201. 557 F.2d at 1023-24.

202. *Id.* at 1026.

203. *Id.*

204. *Id.* at 1026-27.

205. *Id.* at 1028.

206. *Id.* at 1027-28.

207. *Id.* at 1028.

208. *Id.*

ceptually intertwined, but the "in connection with" requirement requires a slightly different analysis.²⁰⁹ In downplaying the role of causation, the court seemed to be at odds with another Third Circuit case of the same year in which an intracorporate power struggle was held not to implicate 10b-5. In that case, *Tully v. Mott Supermarkets, Inc.*,²¹⁰ the panel found the "in connection with" requirement unsatisfied, in part because there was a lack of causal connection between the fraud and the securities transaction.²¹¹ That two panels of the same court can be at odds with one another on such a matter in the same year is perhaps an illustration of the difficulty and confusion surrounding the "in connection with" requirement.²¹²

The fifth principle discussed by the court in *Ketchum* is related closely to the incidental/essential distinction. The court noted that the *purpose* of the deception was not to cause a stock sale; rather, the purpose was to oust the plaintiffs from their position of control.²¹³ The securities transaction was a mere consequence.²¹⁴ This is what differentiates later cases which were decided on facts seemingly similar to *Ketchum*. In both *McGrath v. Zenith Radio Corp.*²¹⁵ and *Brown v. Ivie*,²¹⁶ the courts distinguished *Ketchum* by noting that in *Ketchum* the purpose of the scheme had been ouster; the securities transaction was merely incidental. In the cases before them, the *McGrath* and *Brown* courts noted that the purpose of the schemes was to obtain securities at discount; the ouster was simply the mechanism used.²¹⁷

Finally, the court pointed out that there should be an automatic bias against using 10b-5 to resolve intracorporate disputes. That is, courts should be hesitant to expand the federal securities laws into the corporate arena.²¹⁸

Ketchum may be criticized on many grounds. For example, it is not clear that the stock sale was merely an incidental consequence of the scheme. Since the plaintiffs were majority shareholders, they

209. *Id.* at 1029.

210. 540 F.2d 187 (3d Cir. 1977).

211. *Id.* at 194.

212. The phenomenon is not as unusual as one might think, however. See Solimine, *Ideology and En Banc Review*, 67 N.C.L. REV. 36, 39-40 n.36 (1988).

213. *Ketchum*, 577 F.2d at 1028.

214. *Id.*

215. 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981).

216. 661 F.2d 62 (5th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982).

217. *McGrath*, 651 F.2d at 467; *Brown*, 661 F.2d at 65.

218. *Ketchum*, 577 F.2d at 1029.

could not be ousted unless their stock were taken. Also, the principle of exclusive alternatives is of questionable assistance in applying the “in connection with” requirement.²¹⁹ Nonetheless, the opinion is valuable for the variety of principles discussed, and as an illustration of the conceptual struggle involved in trying to apply this rather slippery 10b-5 requirement.

Also important to note is the degree of cross-fertilization between the different categories of “in connection with” cases. Many of the principles discussed by the court in *Ketchum* appear in other categories of cases as well, yet none of the courts’ opinions question the propriety of using a given set of principles for obviously different fact patterns.

E. Category 5: Misappropriation Cases

Without a doubt the most topical category of cases involving the “in connection with” requirement is that involving insider trading following the misappropriation of information. In a classic instance of insider trading, a corporate insider—for example, an officer or director of the firm—uses material non-public information to trade with his own shareholders. Courts have long recognized such a case as an instance of deception (silence in the face of a fiduciary duty to speak),²²⁰ and without question such deception is in connection with the purchase of the securities from the shareholder.²²¹ In a misappropriation case, however, the facts are different: an insider in Firm A commits a deception on Firm A by “misappropriating” through stealth valuable non-public information, which the insider uses to trade with the shareholders of Firm B. The important question for our purposes in such cases is not whether there was a deception—stealth is necessary to the misappropriation;²²² rather, the important question is whether that deception on Firm A can be said to be “in connection with” the trading with Firm B’s shareholders.

The Second Circuit has faced this question squarely in three well-

219. See *supra* notes 154-56 and accompanying text; *infra* note 273 and accompanying text.

220. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

221. Such a case is indistinguishable from category 1 cases once the element of deception is posited.

222. An interesting question, of course, arises as to whether this sort of implicit deception through breach of duty (as opposed to an explicit information-based deception) is sufficient in light of the Supreme Court’s holding in *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), that a breach of a corporate manager’s implicit representation that he will act in conformity with fiduciary duty principles is not the sort of deception that 10b-5 reaches. *Id.* at 477. The Supreme Court seemed to suggest in that case that the deception must be informationally based, rather than a mere breach of the implicit representation that one will comply with fiduciary duties. See *Pross v. Katz*, 784 F.2d 455, 458 (2d Cir. 1986). Such a question is beyond the scope of this article.

publicized and controversial cases. In each one,²²³ the Second Circuit has answered the question in the affirmative: if one commits deception by misappropriating material non-public information from Firm A and uses that information to trade with Firm B's shareholder, one commits a deception that is in connection with that trading activity.

In the first of the three Second Circuit misappropriation cases, *United States v. Newman*,²²⁴ the court dealt with the "in connection with" requirement only summarily. The defendant's sole purpose in committing the deceptive misappropriation was to purchase securities. Thus, the court found "little merit in his disavowal of a connection between the fraud and the purchase."²²⁵ The "purpose" rationale appears in other categories as well,²²⁶ but in the misappropriation cases it becomes a focal point.

Thus, in the second case of the trilogy, *SEC v. Materia*,²²⁷ the court found the "in connection with" requirement satisfied because the deception was part of a scheme whose purpose was to facilitate profitable trading in securities.²²⁸ It was not until the third Second Circuit case was decided that the court began to expand its rationale for finding the "in connection with" requirement satisfied.

Perhaps because of the controversy that arose concerning the Second Circuit's use of 10b-5 in misappropriation cases,²²⁹ in *United States v. Carpenter*²³⁰ the court offered a more in-depth explanation for its view that in such cases the deception is in connection with the purchase or sale of securities. The court again emphasized the "purpose" rationale by pointing out that the deception was of no value to the defendant except to the extent it allowed him to trade securities profitably.²³¹ The court went on, however, to suggest that the "in connection with" standard is a broad one, citing *Bankers Life* and

223. The individual fact patterns of the three cases are substantially identical in structure for purpose of analysis under the "in connection with" requirement.

224. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1982).

225. *Id.* at 18.

226. *See infra* notes 284-93 and accompanying text.

227. 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1073 (1985).

228. *Id.* at 203.

229. *See, e.g.,* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-"Chiarella" Restatement*, 70 CALIF. L. REV. 1, 47 (1982); Wang, *Recent Developments in the Federal Law Regulating Stock Market Inside Trading*, 6 CORP. L. REV. 291, 302 (1983) (questioning the satisfaction of the "in connection with" requirement in misappropriation cases).

230. 791 F.2d 1024 (2d Cir. 1986), *aff'd by equally divided Court*, 108 S. Ct. 316 (1987).

231. *Id.* at 1033.

Competitive Associates.²³² Interestingly, the court failed to take note at all of the many cases,²³³ including recent ones from its own circuit,²³⁴ suggesting that the “in connection with” requirement is more strict than some would suggest.

The *Carpenter* court also made a rather feeble attempt to use the causation rationale that is so central to category 1 and category 2 cases.²³⁵ It reasoned that the parties with whom the defendant traded would not have sold stock to the defendant had they known of the deceptively acquired information.²³⁶ That undoubtedly is true, but it is not helpful. For the deceptive conduct to be even a “but for” cause of the “victims’” trades, it must be asserted that those who were selling at the same time the defendant was buying would not have sold if the defendant had not engaged in the deceptive misappropriation. In an anonymous auction market, that statement of causation simply cannot be made. Arguably, “but for” the misappropriation, the securities trades by the defendant would not take place, therefore causation exists. But this sort of causation is an extremely weak form. A misappropriation of information causes a securities trade only in the same sense that long weeks of preparation “cause” a mountain climber to scale Mount Everest. Causation, to have any real meaning, must be of a stronger type. Thus the causation rationale, stated by some courts as the touchstone of the “in connection with” requirement,²³⁷ fails in the category 5 cases.

If the “in connection with” requirement necessitates causation, that requirement is unsatisfied in the misappropriation cases. This lack of causation does not mandate the conclusion that the misappropriation cases of the Second Circuit have been wrongly decided; rather, it would be a mistake to require the causation principles to

232. *Id.*

233. *See, e.g.*, *Head v. Head*, 759 F.2d 1172 (4th Cir. 1985) (rule 10b-5 elements not met merely by “linking the ‘sale’ in the escrow transaction to alleged fraud in the prior property settlement”); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977).

234. *See, e.g.*, *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984). In that case, Judge Friendly, writing for the court, impliedly approved of the circuit’s holding that trading on the basis of misappropriated information violated 10b-5. *See id.* at 944 n.24.

235. *See supra* notes 85-93, 102-17 and accompanying text.

236. *Carpenter*, 791 F.2d at 1032.

237. *See, e.g.*, *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 943 (3d Cir.) (court construed “touching requirement as mandating that there be some causal connection between the alleged fraud and the purchase or sale of a security”), *cert. denied*, 106 S. Ct. 267 (1985); *SEC v. Penn Cent. Co.*, 450 F. Supp. 908, 912-13 (E.D. Pa. 1978) (court stated that if “misrepresentations to the corporations and to the public in fact occurred and involved conduct which was virtually indistinguishably linked in a causal chain, we would certainly find that the fraud ‘touched’ the purchase or sale of securities”); *Crummere v. Smith Barney, Harris, Upham & Co.*, 624 F. Supp. 751 (S.D.N.Y. 1985).

support the "in connection with" requirement in both the misappropriation cases and other categories as well. Properly understood, the "in connection with" requirement necessitates the use of different principles in widely disparate fact situations.

Perhaps the most challenging rationale offered by the *Carpenter* court for its finding that the "in connection with" requirement was satisfied was its assertion that interpreting the requirement in that way fulfilled the purposes and policies of section 10(b), rule 10b-5, and the securities laws generally.²³⁸ Citing legislative material almost exclusively from recent years,²³⁹ the court emphasized the nearly universal desire to ensure the fairness of the markets to all participants and to create a level playing field for all investors.²⁴⁰

Commentators are split on the soundness of the Second Circuit's²⁴¹ conclusion that the deceptive misappropriation of information is in connection with the trading on such information.²⁴² Professor Barbara Aldave has championed the misappropriation cases for the two primary rationales supporting the *Carpenter* decision: the purpose of the deception and the policies implicated.²⁴³ These rationales are taken up in more detail below.²⁴⁴ However, when comparing the misappropriation cases with other categories of cases, an interesting development is seen: The courts are shifting their emphasis away from certain principles for application of the "in connection with" requirement toward others. Perhaps they recognize the limited use of principles from other categories in deciding misappropriation cases.

238. *Id.* at 1029-33.

239. As discussed *infra* notes 250-52 and accompanying text, the legislative history for section 10(b) and rule 10b-5 is scant and indicates clearly that neither Congress nor the SEC contemplated using the section or the rule to combat insider trading at all, much less misappropriation cases.

240. *Carpenter*, 791 F.2d at 1029-32.

241. The misappropriation theory seems to be catching on in other jurisdictions as well. In *SEC v. Clark*, No. C87-711Z (W.D. Wash. Sept. 8, 1988) (LEXIS, Genfed library, Courts file), a judge in the Western District of Washington adopted the theory explicitly and pointed out that in *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985), *cert. denied*, 107 S. Ct. 1895 (1987), the Third Circuit seemed to accept the theory implicitly. Neither opinion discussed the "in connection with" requirement.

242. Compare, e.g., *Langevoort*, *supra* note 229, at 46-47; Cuevas, *The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court*, 13 J. CORP. L. 793, 813-14 (1988) (criticizing the theory for ignoring a lack of "nexus between the misappropriating of information and the purchase or sale of securities"); and Wang, *supra* note 229, at 302 (questioning the satisfaction of the "in connection with" requirement in misappropriation cases); with Aldave, *The Misappropriation Theory: Carpenter and its Aftermath*, 49 OHIO ST. L.J. 373, 377-80 (1988).

243. See Aldave, *supra* note 242, at 377-80.

244. See *infra* notes 284-92, 320-26 and accompanying text.

Alternatively, they may be recognizing that the use of certain principles from other categories would lead to an undesired result. For example, as already noted, requiring causation would lead to the conclusion that the misappropriation was not in connection with the purchase or sale. Similarly, a requirement that the deception concern specific securities would lead to an opposite result than the one reached by the Second Circuit in these cases. Perhaps for that reason these other principles are simply ignored.

F. *Category 6: The Conversion of Securities*

In category 6, we return nearly to the level of consensus that was present in category 1. Whereas in category 1 courts uniformly find the "in connection with" requirement satisfied, in category 6 near uniformity of opinion can be found at the other end of the spectrum: courts generally hold that a mere conversion of stock—almost always a deceptive act—is not deception in connection with the purchase or sale of securities.²⁴⁵

What makes this category of cases interesting is not simply that they arguably lie on the other end of the spectrum from category 1 cases. Rather, the conversion cases are interesting because the courts do not seem to see the structural parallels between the conversion of securities followed by a sale of those securities and the misappropriation of material non-public information followed by the purchase of securities.

One can imagine a scenario in which an investor has securities converted from him by a defendant. That conversion is of the same type of inherently deceptive act found adequate in the misappropriation cases. Unless the defendant intends to hold the securities indefinitely for investment purposes, he will sell them.²⁴⁶ If the defendant

245. See, e.g., *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986); *Bohicchio v. Smith Barney, Harris, Upham & Co.*, 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986); *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1564-66 (E.D.N.Y. 1985); cf. T. HAZEN, *supra* note 22, § 13.6, at 120 (1985 & Supp. 1988) ("Thus, a conversion of securities will not support a 10b-5 claim without a showing that it was fraudulently induced."). But see *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964) (allegation that banks loaned plaintiff money to buy securities with the fraudulent intent later to convert those securities stated claim under 10b-5). These cases are analogous to those in which the plaintiff alleges that he was induced through fraud to retain securities, then sold them later at a loss. Courts are split on the question whether the alleged fraud is in connection with the later sale. Compare, e.g., *Bolger v. Laventhol, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 266 (S.D.N.Y. 1974) (the "mere retention of securities and a deferred sale do not satisfy the 'in connection with' nexus") with *Feldberg v. O'Connell*, 338 F. Supp. 744, 746-47 (D. Mass. 1972) (contra). See also *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 219 (S.D.N.Y. 1965). "A seller is injured as much when he suffers a loss on the sale of securities which he has been fraudulently induced to retain as when he is fraudulently induced to sell them." *Id.*

246. If there never is a sale of the converted securities, the case clearly does not implicate 10b-5—the rule clearly requires that there be a purchase or sale at some

converted the securities with the intent ultimately to sell them, thereby realizing the desired profit from the transaction, the structure of the case is almost indistinguishable from the misappropriation cases. One can point out that the sole purpose for the defendant's deceptive conversion was to profit by selling the securities. The deception seems structurally as much in connection with the securities transaction as that involved in the misappropriation cases. Yet the outcome of the cases is markedly different.

The most probable explanation for the divergent results in these two structurally similar fact patterns is that the structure of the misappropriation cases is not sufficient to justify the result. The mere fact that the purpose of the deception was to permit a later securities transaction is simply not what makes the misappropriation cases seem appropriate for application of 10b-5. Rather, what undoubtedly has compelled the Second Circuit's development of the misappropriation theory from the start has been its view of the impact that such a transaction has on securities markets and securities buyers and sellers. In other words, the more detailed rationale offered by the *Carpenter* court—that the misappropriation cases satisfy the "in connection with" requirement because to so hold better serves the policies of the federal securities laws—is what really lies alone behind the theory. There is no other way to reconcile the misappropriation cases with the conversion cases.²⁴⁷ The sufficiency of that policy rationale as a justification for interpreting the "in connection with" requirement in a given way is the linchpin for the misappropriation theory.

V. MATCHING PRINCIPLES AND CATEGORIES

In part IV, three facts became apparent. First, courts use a large number of principles or rationales in deciphering the "in connection with" requirement. Second, the types of cases in which courts are forced to apply the requirement are disparate, mirroring the explosive use of 10b-5 to cover a wide range of fact patterns. Third, courts

point in the transaction. From the victim's point of view, of course, what the defendant ultimately does with the securities is of no concern. Therefore, if 10b-5 is used when there is a conversion followed by a sale, but not when there is a simple conversion, the difference in outcomes turns on a fortuity (from the victim's point of view) necessitated by the statutory language.

247. Indeed, much of the conversion case law comes from the Second Circuit. See, e.g., *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986); *Bochicchio v. Smith Barney, Harris, Upham & Co.*, 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986); *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1564-66 (E.D.N.Y. 1985).

are in a state of confusion concerning the proper principles to use in given fact patterns and seem to be unaware of the dissimilarities between the various types of cases in which the “in connection with” requirement arises. At the same time, their confusion is manifested in their failure to explain why they seem willing to use certain principles cross-categorically sometimes and yet eschew principles from other categories in other cases. One senses a complete unawareness of the problem.

The purpose of part V is to attempt to sort out those principles and categories with the ultimate aim of formulating a list of appropriate “in connection with” inquiries for each of the six categories of cases described in part IV. Section A sets the groundwork by examining each of the many principles used by courts. Most of the principles have been at least mentioned in part IV, but some have not. In section A the principles are sorted through in an attempt to determine which are viable at all and, of those that are viable, the types of cases in which they are viable. Section B then summarizes the section A analysis by going through the categories one by one and pointing out the inquiries appropriate for a court to make in determining whether the “in connection with” requirement is satisfied.

A. Examining the Principles

The principles that may be useful in the interpretation of the “in connection with” requirement can be broken down into two types: general principles of limitation and specific principles of application. General principles of limitation are those useful, not as tests or touchstones for the “in connection with” requirement, but as general statements concerning the parameters of possible outcomes. They might suggest, for example, that the requirement is a broad one that imposes little limitation on the types of cases that may arise under 10b-5. Alternatively, they might suggest that there are limits that the “in connection with” requirement places on 10b-5. General principles of limitation set the boundaries for our discussion; they help describe the spectrum of cases that may be deemed to satisfy the “in connection with” requirement.

Specific principles of application offer more guidance. Courts attempt to use them as touchstones at times. Further, they posit the proper questions to be asked when faced with the task of deciding whether a particular act of deception was in connection with this particular sale of stock.

There is a certain artificiality to the distinction between the two types of principles, but the distinction is helpful in understanding the use to which given principles may properly be put. Courts err when

they conclude simply from general principles of limitation that the "in connection with" requirement is either satisfied or not satisfied.

1. General Principles of Limitation

Courts interpreting the "in connection with" requirement are fond of broad statements of legal principles that purport to offer guidance in application of the requirement. In this section, four such principles used by courts in the past are examined first. An examination of those broad principles shows them to be varied in their helpfulness. Then, three new principles of limitation are presented that should guide courts in their selection of more specific principles of application.

- a. *Limitation Principle 1: Rule 10b-5 should be interpreted flexibly, not restrictively, to protect and effectuate its broad remedial purposes.*

This popular generality, which originated in *SEC v. Capital Gains Research Bureau, Inc.*²⁴⁸ more than twenty-five years ago is almost worthless. First, it originated in the halcyon days of unlimited expansion of 10b-5. More recent Supreme Court cases have properly noted that there are limits to the "flexibility" of 10b-5; the rule is to be read more "restrictively" in important ways than had been the case in the past.²⁴⁹ Maxims of an earlier time in which the climate for 10b-5 cases was different are thus of limited guidance today.

Second, 10b-5 has no "broad remedial purposes" as a matter of history. It was drafted and adopted in a single day to deal with a company president in Boston who was buying the shares of his company through using misrepresentations. Rule 10b-5's only purpose was to close a loophole in the antifraud provisions whereby under section 17(a) of the 1933 Act, fraud in the sale of securities was a crime, but fraud in the purchase of securities was not.²⁵⁰ Further, any statements concerning section 10(b)'s broad purposes are wholly without support, since there is almost no legislative history for the section.²⁵¹

248. 375 U.S. 180, 195 (1963).

249. See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462, 473-74 (1977) (rule 10b-5 limited by section 10(b), which requires deception or manipulation); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (rule 10b-5 requires showing of scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-33 (1975) (plaintiff must be actual purchaser or seller of securities).

250. See *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (statement of Mr. Milton Freedman).

251. Accord Comment, *Securities Law—Rule 10b-5—For Fraud to be "In Connec-*

The only meaningful statement during hearings on the 1934 Act was made by Thomas Corcoran, who skipped over section 10(b) by noting it was a general catchall for manipulative devices, not mentioning at all the “deceptive” language in the section,²⁵² which is the basis for all the interesting “in connection with” cases.²⁵³ Thus, there is no justification for using this principle to rationalize a loose “in connection with” requirement.²⁵⁴

- b. *Limitation Principle 2: The “in connection with” requirement should be interpreted loosely because Bankers Life stated that the fraud need only “touch” the securities transaction.*

Drawing from the touching language of *Bankers Life*, the proposition that the “in connection with” requirement should be interpreted loosely is a mistake for reasons discussed above:²⁵⁵ there is nothing in the notion of “touching” that implies necessarily either a loose or a tight nexus requirement; the phrase from Justice Douglas’ opinion in which that concept is drawn was merely that justice’s literary style restating the requirement; that case was decided in a different 10b-5 era predating a more restrictive approach by the Supreme Court. Those points are made above and need not be repeated at length here. The *Bankers Life* phraseology offers no guidance.

tion With” A Purchase or Sale of Securities Under Section 10(b), Plaintiffs Must Allege a Causal Connection and Close Degree of Proximity Between the Purchase or Sale of Securities and Defendants’ Fraudulent Scheme—Ketchum v. Green, 557 F.2d 1022 (3d Cir.), cert. denied, 98 S. Ct. 431 (1977), 46 GEO. WASH. L. REV. 482, 484 n.17 (1978); Note, Securities Regulation—Rule 10b-5—The Supreme Court’s Holding in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971), May Force a Renewed Search for a Limiting Doctrine for Rule 10b-5 Liability, 50 TEX. L. REV. 1273, 1273 n.3 (1972).

252. *Stock Exchange Regulation, Hearings on HR 7852 and HR 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934)* (remarks of Mr. Thomas Corcoran). Section 10(b)’s scant legislative record is traced in *Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201-07 (1976)*.

253. Manipulation is a term of art that describes practices such as matched buy-sell orders, false touts, and attempts to corner a market. See *Santa Fe Indus. v. Green, 430 U.S. 462, 476 (1977)*. Because manipulation of securities prices will *always* be in connection with the purchase and/or sale of those securities, the only controversies concerning the “in connection with” requirement will come in deception cases.

254. See *DMI Furniture, Inc. v. Brown, Kraft & Co., 644 F. Supp. 1517, 1528 (C.D. Cal. 1986)* (to say that courts should interpret the “in connection with” clause broadly to protect investors offers no guidance).

255. See *supra* notes 62-64 and accompanying text.

- c. *Limitation Principle 3: The "in connection with" language of rule 10b-5 and section 10(b) should be interpreted broadly, since by using the language "in connection with," Congress indicated its intent that a looser standard apply in section 10(b) cases than in 1933 Act section 17(a) cases, where the requirement is that the fraud be "in the sale of securities."*

In an attempt to extract some guidance from the statutory framework, some courts have noted the difference in language used in section 17(a) of the 1933 Act²⁵⁶ and section 10(b) of the 1934 Act.²⁵⁷ Section 17(a) proscribes fraud "in the sale of securities," whereas section 10(b) proscribes fraud "in connection with" the purchase or sale of securities. Some courts have drawn the implication that Congress must have intended that section 10(b)'s required nexus be of a looser type than that required for section 17(a) cases.²⁵⁸ Other courts have rejected such a suggestion,²⁵⁹ and a few, including the Supreme Court, have exhibited non-committal skepticism on the question.²⁶⁰

Despite the difference in language used in the two sections, there is nothing in the legislative history of section 10(b) to indicate that Congress was even aware of the difference. As Judge Friendly once pointed out in rejecting the argument that "in connection with" is necessarily broader than "in," "courts sometimes err in attributing substantive importance to what may well have been only a draftsman's choice of slightly different language."²⁶¹ In the *Bankers Life* decision, Justice Douglas even made the statement that what section

256. 15 U.S.C. § 77q (1982).

257. 15 U.S.C. § 78j(b) (1982).

258. See, e.g., *SEC v. Penn Cent. Co.*, 450 F. Supp. 908, 916 (E.D. Pa. 1978). "Plaintiff will have to demonstrate at trial a more direct involvement in the offer or sale of securities to make out a § 17(a) violation than is necessary to establish a violation of § 10(b) or Rule 10b-5." *Id.* *Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp. 715, 718 (S.D.N.Y. 1968) (words of section 10(b) and rule 10b-5 "have been construed more liberally in order to carry out the intent of the act").

259. *Somogyi v. Butler*, 518 F. Supp. 970, 983 n.13 (D.N.J. 1981) ("in connection with" requirement and definition of "security transaction" apply with equal force to section 17(a)).

260. See *United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979) (stating that the Court is "not necessarily persuaded" that "in" is narrower than "in connection with"); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984); *SEC v. Warner*, 652 F. Supp. 647, 651 (S.D. Fla. 1987). "It is unclear whether the § 17(a) requirement that the fraud be 'in' the offer or sale connotes a narrower range of activities than does the 'in connection with' requirement of § 10(b)." *Id.*

261. *Chemical Bank*, 726 F.2d at 942.

10(b) prohibits is fraud *in* the purchase or sale of securities.²⁶² Although it would be comforting to find a tidy statutory solution to the “in connection with” problem, to draw any instrumental conclusions from the difference in language is to read too much into the statutes.

d. Limitation Principle 4: Not just any wrongdoing that happens to occur in the same fact setting with a purchase or sale of securities occurs “in connection with” that purchase or sale.

This general proposition is stated often by both courts²⁶³ and commentators.²⁶⁴ The proposition is true, but it offers almost no substantive guidance. It is obviously true, because if it were false, the “in connection with” requirement would impose no limitation at all. Even the scenario A set forth in part I above²⁶⁵ (in which a shoe salesman commits fraud in shoe sales and simultaneously sells securities honestly) would implicate 10b-5.

But this general proposition is simply another way of saying that the “in connection with” requirement has limits. It does not indicate what those limits are. In practice, the proposition is used as a warning about overreaching arguments or as a foreshadowing by courts. Typically, the proposition is stated, then more detailed rationales are given for why the court is ruling the “in connection with” requirement unsatisfied.²⁶⁶ For less general limits, principles of application are necessary.

In addition to these four principles of limitation—of which only the fourth is viable—three other possibilities exist.

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

263. *See, e.g., Hunt v. Robinson*, 852 F.2d 786, 787 (4th Cir. 1988) (“Fraudulent non-conveyance . . . not transformed into a federal claim simply because the object of the bargain was shares of stock”); *In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986) (insufficient to allege that fraud and the purchase or sale of securities occurred in same transaction); *Head v. Head*, 759 F.2d 1172, 1175 (4th Cir. 1985); *DMI Furniture, Inc. v. Brown, Kraft & Co.*, 644 F. Supp. 1517, 1528 (C.D. Cal. 1986). “[N]ot every person who performs an act which could be deemed to involve a security is held to have acted ‘in connection with’ a securities transaction.” *Id. Smith v. Murchison*, 310 F. Supp. 1079, 1085 (S.D.N.Y. 1970). “Plaintiff may not convert a state law claim into a Rule 10b-5 claim simply by alleging that it was a defrauded party and that at some time a purchase or sale of a security was made.” *Id.*

264. *See, e.g., T. HAZEN, supra* note 22, § 13.6, at 120 (1985 & Supp. 1988) (“The ‘in connection with’ requirement will not support a 10b-5 action for any wrongdoing that happens to involve a security.”); Note, *supra* note 251, at 1280.

265. *See supra* note 7 and accompanying text.

266. *See cases cited supra* note 263.

- e. Limitation Principle 5: In each category of "in connection with" cases, there must be recognized some principle of application that imposes some limits on our ability to claim that the deception is in connection with the securities transactions.*

Because the "in connection with" requirement must have some limits, it follows that for any given category of cases, we must be prepared to recognize at least one principle that acts as a limit in that particular category. A given category may have such a limit simply because of the structure of the category—that is, the way in which the category is described. For example, although all category 1 cases satisfy the "in connection with" requirement, there are inherent limits in those types of cases: the securities fraud involved always entails causation, the deception always goes to the merits of the security being traded, and the defendant is always a trader.²⁶⁷ Although limits may not exist in other categories of cases, they do exist in the category 1 cases. Limits must be identified for every category.

- f. Limitation Principle 6: The defendant's conduct should always be of a type colloquially characterized as "securities fraud."*

Ultimately, asking "Is this securities fraud?" begs the question. Yet a form of that question can be helpful. Although the legislative history for section 10(b) is sketchy at best, common sense indicates that what Congress was trying to do in enacting that section was to prohibit what both it and we colloquially refer to as "securities fraud." Congress was undoubtedly motivated by contemplation of a set of paradigms of securities fraud—the Platonic form of securities fraud. Indeed only six years after a private right of action was first recognized for 10b-5, an august panel of the Second Circuit suggested that the rule was directed only at those types of deceptions or fraudulent practices normally associated with the sale or purchase of securities.²⁶⁸ Thus, by asking whether this is what is colloquially referred to as securities fraud, the real question becomes: "How close does this

267. *Cf. Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339, 362-63 (N.D. Ohio 1976) (allegation of misrepresentation in offering circular of stock seller establishes sufficient "nexus" for 10b-5).

268. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). *But see A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 396-97 (2d Cir. 1967) (rejecting notion that 10b-5 is limited to ordinary securities fraud). The panel in *Birnbaum* was made up of Judge Swan and the Hand brothers, Learned and Augustus.

come to the paradigmatic situation Congress undoubtedly had in mind in enacting section 10(b)?" It is in answer to this question that what is referred to above²⁶⁹ as "the principle of greatest possible connection" arises: where the facts show a case representing the paradigm, it is difficult to deny the connection. The further away from the paradigmatic category 1 case, the less the case feels to a court like "securities fraud." Consequently, a court should be also less willing to find the "in connection with" requirement satisfied. This requires an exercise of judgment, but that after all is what judges do.

g. Limitation Principle 7: No person should be found to have committed fraud in connection with the purchase or sale of securities unless that person was an actual purchaser or seller of securities.

A fundamental ambiguity exists in the wording of section 10(b). When Congress prohibits deception and manipulation in connection with the purchase or sale of securities, is the "purchase or sale" language directed at the perpetrators or the victims? That is, did Congress mean to prohibit deception and manipulation in connection with the investing public's (*i.e.*, the victim's) purchases and sales, or did Congress mean to prohibit deception and manipulation in connection with the perpetrator's purchases or sales? The better interpretation is the latter.

First, it better comports with the structure of the statute. The statute reads in relevant part: "It shall be unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security, . . . any manipulative or deceptive device or contrivance in contravention of [SEC rules]."²⁷⁰ In referring to manipulative or deceptive devices, Congress clearly is referring to acts of the perpetrator. By interpreting the "purchase or sale" language also to refer to acts of the perpetrator, the consistency of the internal sentence structure is preserved. Thus, the language used is just an alternative way of saying: "It shall be unlawful for any person to use or employ, in connection with *his* purchase or sale of any security, any manipulative or deceptive device or contrivance." If Congress did not intend a parallel construction, one would expect a clear modification of that structure. For example: "It shall be unlawful for any person to use or employ in connection with *any other person's* sale of security, any manipulative device or contrivance." Either interpretation is *possible*; the question is which is more *probable*.

Two additional points should be made clear about what I suggest is the proper interpretation. First, my interpretation is clearly inconsis-

269. See *supra* note 84 and accompanying text.

270. 15 U.S.C. § 78j(b) (Supp. IV 1986).

tent with the great weight of the case law, which has consistently held that one may be liable under 10b-5 even if one is not a purchaser or seller.²⁷¹ Second, this interpretation does not necessarily foreclose 10b-5 liability for those non-traders who may be liable on an aiding and abetting theory or on an expanded definition of "purchaser" or "seller" beyond the actual transferor or transferee of title. These doctrines have a well-developed jurisprudence of their own,²⁷² and the liability of such non-traders should be determined under that jurisprudence rather than through a misinterpretation of section 10(b).

2. Specific Principles of Application

None of the principles of limitation actually found in judicial opinions is of much use. The worst are simply flawed, and the best—principle 4—is of almost no guidance in actual cases. Further, the three principles of limitation are only designed to be of general guidance. If courts are to be meaningfully guided by principles in applying the "in connection with" requirement to the many categories of cases in which the problem arises, courts must look to more specific principles of application. The more specific principles that have been used are numerous.

a. *Application Principle 1: The principle of exclusive alternatives.*

One of the oddest principles used by courts in rejecting "in connection with" claims is the principle that suggests that fraud cannot be

271. See, e.g., *Sargent v. Genesco, Inc.*, 492 F.2d 750, 759-61 (5th Cir. 1974); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 219 (S.D.N.Y. 1965). See also T. HAZEN, *supra* note 22, § 13.6, at 469 (1985). "It is not necessary that the defendant have been a purchaser or seller of securities in order to be held to have violated rule 10b-5." *Id.* But cf. *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94 (5th Cir. 1975) (the "in connection with" requirement contemplates some sort of privity between plaintiff and defendant) (dictum). In *Basic, Inc. v. Levinson*, 108 S. Ct. 978 (1988), the Supreme Court assumed without deciding that a non-trading issuer could be liable under rule 10b-5 for misleading statements issued by it. The Court, in dictum quoted with approval the *Texas Gulf Sulfur* statement that any person who makes with scienter a false statement "reasonably calculated" to influence the investing public can be liable under rule 10b-5. *Id.* at 985 n.13.

272. See, e.g., O'Hara, *Erosion of the Priority Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 UCLA L. REV. 921 (1984); Rapp, *Expanded Liability Under Section 12 of the Securities Act: When is a Seller Not a Seller?*, 27 CASE W. RES. L. REV. 445 (1977); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972); Comment, *The Recognition of Aiding and Abetting in the Federal Securities Laws*, 23 HOUS. L. REV. 821 (1986).

in connection with two things at once: if the fraud is in connection with something other than a securities transaction, it is not in connection with that securities transaction.²⁷³ Such a principle makes no sense, and its use is unfounded in all circumstances. There is simply no basis for saying, for example, that because fraud is in connection with the mismanagement of a corporation, that fraud cannot be in connection with the purchase or sale of securities, as well.

b. Application Principle 2: Temporal proximity.

Several courts and commentators have suggested that the length of time between the fraudulent conduct and the purchase or sale of securities be taken into account in determining whether such conduct is in connection with the securities transaction.²⁷⁴

The shorter the length of time between the fraud and the securities transaction in question, the more likely the court is to find the "in connection with" requirement satisfied. The purchase and the sale need not follow immediately after the fraud, however, especially if the scheme is a continuing one or if the delay is caused by the defendant's actions.²⁷⁵

There is a certain allure to the suggestion, for when one thinks about the concept of connection, one thinks in terms of proximity—primarily spacial and conceptual, but also temporal. Using temporal proximity to decipher the "in connection with" requirement is a mistake.

One can imagine any instance in which the "in connection with" requirement is clearly satisfied—a classic category 1 case perhaps—then lengthen the time between the fraudulent conduct and the transaction. The "in connection with" requirement is no less satisfied. Just because the victim of the fraud does not make the purchase soon after the fraud has occurred does not make 10b-5 inapplicable.²⁷⁶ Similarly, one can imagine a case in which the requirement is not satisfied—the deceptive shoe salesman/honest securities salesman example from part I would suffice. The 10b-5 case is not strengthened by hypothesizing near simultaneous fraud and securities sales.

The same is true of 10b-5 cases closer to the center of the spectrum. The connection between the fraud and the transaction is not

273. See, e.g., *Hunt v. Robinson*, 852 F.2d 786, 787 (4th Cir. 1988); *Taylor v. First Union Corp.*, 857 F.2d 240 (4th Cir. 1988); *O'Brien v. Continental Illinois Nat'l Bank & Trust Co.*, 593 F.2d 54, 60 (7th Cir. 1979); *Natowitz v. Mehlman*, 567 F. Supp. 942 (S.D.N.Y. 1983); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 99 (S.D.N.Y. 1976). *But see* *Allen Organ Co. v. North Am. Rockwell Corp.*, 363 F. Supp. 1117, 1127 (E.D. Pa. 1973) (defendant's exclusive alternatives argument rejected by court).

274. See, e.g., *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986); *Klausner v. Ferro*, 604 F. Supp. 1188, 1196 (E.D.N.Y. 1985), *aff'd*, 788 F.2d 3 (2d Cir. 1986); A. JACOBS, *supra* note 4, § 38.01, at 2-47; Note, *supra* note 251, at 1280.

275. See Note, *supra* note 251, at 1280.

276. Of course, as time goes by, the victim is less able to make a convincing case of reliance, but that is a separate matter.

heightened by temporal proximity. The principle has a surface appeal, but it does not bear scrutiny.

- c. *Application Principle 3: Fraud in a face-to-face transaction that induces retention of the securities, which are later sold at a loss, is indistinguishable from fraud that induces an immediate purchase or sale.*

In several categories of cases, plaintiffs have alleged that the defendant deceptively induced the plaintiff to retain a security, which the plaintiff later sold at a loss. Courts are split on the question: is the fraud alleged in connection with the later sale?²⁷⁷ The proper answer is no, for at least two reasons.

First, in such a transaction, the perpetrator of the fraud is generally not the person to whom the sale is ultimately made. Section 10(b), properly interpreted, does not impose liability on defendants who are not themselves purchasers or sellers, unless such liability can be imposed on theories (*e.g.*, aiding and abetting, respondeat superior, expanded "seller" concept) unrelated to the "in connection with" requirement.²⁷⁸

Second, even if section 10(b) is interpreted to impose liability on non-trading defendants, the defendants should not be liable when their fraud, induces retention unless the plaintiff can show that the defendant, while committing the fraud, intended that the sale of the security eventually be made. There can be no question that, if the security is never sold, 10b-5 is inapplicable since both section 10(b) and rule 10b-5 require a securities transaction. The section and the rule are not concerned with investment decisions, but with investment decisions that lead to action. If the defendant does not intend in committing the fraud that the transaction ultimately be made, his liability in a "retention-then-sale" case would rest on a complete fortuity—whether the plaintiff decides to realize the loss or not. The wrongdoing involved is the fraudulent inducement of retention, which does not implicate section 10(b). What happens with the security afterwards is logically unrelated to the wrongful conduct. Thus, it should not be deemed to be "in connection with" that conduct.

277. Compare, *e.g.*, *Bolger v. Laventhol, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 266 (S.D.N.Y. 1974) (not in connection with sale) with *Feldberg v. O'Connell*, 338 F. Supp. 744, 746-47 (D. Mass. 1972) (contra) and *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 219 (S.D.N.Y. 1965) (contra).

278. See *supra* note 272 and accompanying text.

This sort of reasoning is implicit in the court's opinion in *Bolger v. Laventhol, Krekstein, Horwath & Horwath*.²⁷⁹ The plaintiffs were partners in a limited partnership that ultimately became worthless, resulting in an eventual sale of the plaintiff's interests.²⁸⁰ The plaintiffs alleged that they were induced by false assurances of the defendants to retain their partnership shares. The court held, however, that fraudulently induced retention, followed by an eventual sale, does not satisfy the "in connection with" requirement.²⁸¹ It pointed out that it was irrelevant to the defendants in deceiving the plaintiffs, whether the plaintiffs ultimately sold or not.²⁸² "The plaintiffs' sale here was not part of the defendants' overall scheme to defraud the limited partners out of their investments."²⁸³

d. Application Principle 4: A defendant's deception should not be deemed to be in connection with a purchase or sale of securities unless the purpose of the fraud was to effectuate a securities transaction.

In several categories discussed above, courts found relevant the purpose of the defendant's deception. In category 1, the deception always has as its purpose the inducement of the securities transaction.²⁸⁴ In category 2, courts are split on whether an issuer's liability under 10b-5, when it makes statements about itself in the markets, depends on whether the issuer intended to affect the trading in its securities.²⁸⁵ Even in the cases in which investors rely on misstatements of third parties, courts often look to the defendant's purpose in making the misstatements.²⁸⁶ In the category 4 mismanagement cases, the purpose of the defendant's acts has been a central point of distinction.²⁸⁷ Of course, in the misappropriation theory, the

279. 381 F. Supp. 260 (S.D.N.Y. 1974).

280. The court assumed *arguendo* that there was a "sale" of the interests when the limited partnership was ultimately dissolved. See *Bolger*, 381 F. Supp. at 266-67.

281. *Id.* at 266.

282. *Id.* at 267.

283. *Id.*

284. See, e.g., *Fleischer*, *supra* note 7, at 1292.

285. See *supra* notes 102-07 and accompanying text.

286. See, e.g., *Jabend, Inc. v. Four-Phase Sys., Inc.*, 631 F. Supp. 1339, 1343-44 (W.D. Wash. 1986) ("in connection with" requirement not satisfied since fraud not calculated to affect investors' decisions); *Crofoot v. Sperry Rand Corp.*, 408 F. Supp. 1154, 1158-59 (E.D. Cal. 1976) ("in connection with" requirement satisfied since defendant's deception was calculated to influence investing public).

287. See *Brown v. Ivie*, 661 F.2d 62, 65 (5th Cir. 1981) (where purpose of allegedly deceptive acts was to force securities transaction, "in connection with" requirement satisfied), *cert. denied*, 455 U.S. 990 (1982); *McGrath v. Zenith Radio Corp.*, 651 F.2d 455, 467 (7th Cir.) (false promises of employment made to achieve sale of securities satisfied "in connection with" requirement), *cert. denied*, 454 U.S. 835 (1981); *Ketchum v. Green*, 557 F.2d 1022, 1028 (3d Cir.) (where purpose of alleged deception was not to cause securities transaction, "in connection with" requirement unsatisfied), *cert. de-*

fact that the securities transaction was the sole purpose of the deception is of central importance to both courts²⁸⁸ and commentators.²⁸⁹ Perhaps because of the pervasive character of this principle, commentators consistently mention it when generally discussing the "in connection with" requirement.²⁹⁰

The principle is a sound one; defendants in all categories should be liable only if the fraud is committed with the purpose of facilitating the securities trade. Two anomalies result if the defendant's purpose is not a requirement. First of all, from the defendant's point of view, the federal securities law implications of his bad conduct become completely fortuitous. Rule 10b-5 liability would turn on events over which the defendant has no control, and about which the defendant does not care.

Perhaps more importantly, however, deceptive conduct which fortuitously results in a securities transaction does not comport with the colloquial understanding of the concept of "securities fraud." In *Ernst & Ernst v. Hochfelder*,²⁹¹ the Supreme Court traced the history of the concept of fraud and found that the notion implies some sort of scienter—unwitting conduct is simply not fraud. Analogously, intentional deception that fortuitously results in a securities trade should not be deemed "securities fraud."

In each of the categories, except that involving the misappropriation cases, a finding that the defendant intentionally committed deception with the purpose of causing a securities trade to take place should be sufficient to establish the requisite connection, at least where the defendant is a buyer or seller of securities. That is, except in the misappropriation cases and those instances in which the defendant is neither a buyer nor a seller, satisfaction of the "purpose" or "intent" principle should be both a necessary and sufficient condition for finding the "in connection with" requirement satisfied.

As discussed below, the misappropriation theory raises special pol-

nied, 434 U.S. 940 (1977); *Herpich v. Wallace*, 430 F.2d 792, 808-09 (5th Cir. 1970) (purchase or sale of securities must be subject or purpose of scheme).

288. See *United States v. Carpenter*, 791 F.2d 1024, 1033 (2d Cir. 1986), *aff'd by an equally divided Court*, 108 S. Ct. 316 (1987); *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1982).

289. See, e.g., *Aldave*, *supra* note 242, at 377-78.

290. See, e.g., A. JACOBS, *supra* note 4, § 38.01, at 2-49; Comment, *supra* note 251, at 496.

291. 425 U.S. 185 (1976).

icy concerns.²⁹² However, the “purpose” principle is an insufficient basis for finding the requisite nexus in misappropriation cases. If deception is accomplished by telling an employer that one is not feeling well, whereas in actuality, the employee is staying home to trade securities with a personal computer, the purpose of the deception is obviously to facilitate securities transactions, just as in the misappropriation cases; but no one would be willing to say that the deception is actionable under 10b-5. The difference between this scenario and the misappropriation cases is that, in the latter, important securities-related policies are implicated differently. Thus, courts make a mistake in the misappropriation case if they focus on the “purpose” principle; they should instead focus on matters of policy.²⁹³

e. Application Principle 5: Causation.

Without doubt, the most common principle stated as a guide for courts in applying the “in connection with” requirement is the principle of causation. As became clear in examining the various categories of “in connection with” cases, causation arises as a rationale, at least implicitly, in nearly all the categories.²⁹⁴ Two questions must be addressed. First, should causation between the fraud and the securities transaction be a necessary condition for finding the “in connection with” requirement satisfied? Second, should causation be a sufficient condition? The answers are, respectively, “generally yes” and “no.”

Except in misappropriation cases, it is sensible to require that the fraud have caused the transaction to take place. Otherwise, the two phenomena—the fraud and the purchase or sale of securities—exist together only coincidentally, either because they occur together in a short span of time or because they happen to occur in the same factual setting. Neither coincidence should be the basis for liability under a securities fraud statute.

In the misappropriation cases, causation (to the extent it is present) is of a different type. Arguably, the deception does not cause the transaction, since from the “victims’” point of view, the transactions would occur even without the defendant’s misappropriation.²⁹⁵ On the other hand, from the defendant’s point of view, the deception causes the transaction (at least in a “but for” sense), since the fraud is necessary for and an intentional precursor to the securities transaction. As mentioned above, however, this type of causation is weak to the point of being meaningless. The deception in such cases is more akin to necessary preparation for, rather than a cause of, the securi-

292. See *infra* note 326 and accompanying text.

293. See *infra* note 326 and accompanying text.

294. See *supra* notes 82-247 and accompanying text.

295. This point is explored *supra* notes 235-37 and accompanying text.

ties transaction. But again, the misappropriation cases raise entirely different sorts of policy questions and must be treated differently.

As a sufficient condition for the satisfaction of the "in connection with" requirement, causation clearly fails.²⁹⁶ Allowing mere causation ("the fraud caused the plaintiff to trade securities") to satisfy the "in connection with" requirement would be counter to the requirement that the defendant be an actual purchaser or seller.²⁹⁷ Further, it would require the rejection of the "intent" or "purpose" principle already suggested as a necessary condition.²⁹⁸

f. Application Principle 6: Temporal sequencing.

Although there should be no requirement that the fraud precede the securities transaction by only a short period of time,²⁹⁹ it makes sense to require that the fraud at least not occur *after* the securities transaction takes place. This is simply a corollary of the causation requirement, and seems a pedestrian notion. However, courts find themselves having to state it often, apparently because plaintiffs have been sufficiently heartened by the expansive use of 10b-5 that they have been willing to make the rather audacious argument that fraud can be "in connection with" the purchase or sale of securities even when the deception postdates the transaction.³⁰⁰

g. Application Principle 7: The more intervening steps which exist between the fraud and the purchase or sale of securities, the lesser is the connection between the two.

In at least two cases, circuit courts have found it relevant to inquire into the number of intervening steps between the deception and the

296. *Accord* Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir.) ("but for" causation insufficient), *cert. denied*, 469 U.S. 884 (1984).

297. *See supra* notes 270-72 and accompanying text.

298. *See supra* notes 284-93 and accompanying text.

299. *See supra* notes 274-76 and accompanying text.

300. *See, e.g.*, *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646 (9th Cir. 1988); *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986); *Shivers v. Amerco*, 670 F.2d 826, 829-30 (9th Cir. 1982); *Connors v. Lexington Ins. Co.*, 666 F. Supp. 434, 443 (E.D.N.Y. 1987); *Citron v. Rollins Envtl. Serv., Inc.*, 644 F. Supp. 733, 737 (D. Del. 1986); *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1566 (E.D.N.Y. 1985); *Gulf Corp. v. Mesa Petroleum Co.*, 582 F. Supp. 1110, 1121 (D. Del. 1984); *Troyer v. Karcagi*, 476 F. Supp. 1142, 1148 (S.D.N.Y. 1979); *Wolford v. Equity Resources Corp.*, 424 F. Supp. 670, 671 (S.D. Ohio 1976); *Lester v. Preco Indus.*, 282 F. Supp. 459, 462 (S.D.N.Y. 1965); *Eisenstadt v. Josephthal & Co.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,971, at 90,845 (S.D.N.Y. Mar. 27, 1985).

purchase or sale of securities. In *Ketchum v. Green*,³⁰¹ the court found the “in connection with” requirement unsatisfied, in part because of the number of intervening acts that took place between the fraud and the sale of securities.³⁰² In *Buffo v. Graddick*,³⁰³ the court found a state corollary of the 10b-5 “in connection with” requirement satisfied where the transaction was only one step away from the fraud.³⁰⁴

Such an inquiry may be appropriate in determining causation, but as a separate consideration it adds nothing. If the court determines that the fraud actually caused the securities transaction to occur, it should not matter at all that there was a long chain of events between the two.

h. Application Principle 8: The incidental/essential distinction.

One of the most common inquiries made by courts in many categories of cases involves whether the purchase or sale of securities was an “incidental” or “essential” part of the defendant’s fraud, although the phraseology used varies.³⁰⁵ Commentators, too, are inclined to make the distinction.³⁰⁶ In cases and commentary, it is sometimes not clear whether the discussion is (a) inquiring whether the transaction was a purpose for the fraud, (b) inquiring into the transactional proximity between the fraud and the transaction, or (c) stating a separate principle.

If the distinction is used as a reformulation of the “purpose” or “intent” requirement, it either adds nothing, or it adds too much. If courts are using the distinction simply as an alternative formulation of the “purpose” or “intent” requirement, it adds nothing and is a less clear formulation. If, however, courts are suggesting that the defendant must not only have intended that his deception cause the

301. 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977).

302. *Id.* at 1028.

303. 742 F.2d 592 (11th Cir. 1984).

304. *Id.* at 596-97.

305. See *Taylor v. First Union Corp.*, 857 F.2d 240 (4th Cir. 1988); *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 944 n.24 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984); *Ketchum v. Green*, 557 F.2d 1022, 1028 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977); *Marshall v. AFW Fabric Corp.*, 533 F.2d 1277, 1282 (2d Cir.), *reh'g en banc denied*, 533 F.2d 1309 (2d Cir.), *vacated*, 429 U.S. 881 (1976); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 430 F.2d 355, 362 (2d Cir. 1970) (Hays, J., dissenting), *rev'd*, 404 U.S. 6 (1971); *Natowitz v. Mehlman*, 567 F. Supp. 942, 947 (S.D.N.Y. 1983); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539, 543 (N.D. Ill. 1970); *Smith v. Murchison*, 310 F. Supp. 1079, 1086 (S.D.N.Y. 1970); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 300 F. Supp. 1083, 1101 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355, 362 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971); *Lester v. Preco Indus.*, 282 F. Supp. 459, 462 (S.D.N.Y. 1965); *Bailey v. North Jersey Trust Co.*, 226 F. Supp. 972, 978 (1964); *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 25 (S.D.N.Y. 1963).

306. See, e.g., 5B A. JACOBS, *supra* note 4, § 38.01, at 2-49; Note, *supra* note 251, at 1280.

transaction but also that causing the transaction was an "essential," in the sense of "dominant" or "primary," reason for the deception, the suggestion is too strong. Intentional deception when buying or selling securities is no less a matter of federal concern if the deception is really a means to another end as well. It makes no difference from either the defendant's or victim's point of view.

If the distinction is made simply as a restatement of the principle of transactional proximity, the comments below concerning that principle are applicable.³⁰⁷ If, however, the incidental/essential distinction is used by courts or commentators as a separate consideration, its use is a mistake. Although it has surface appeal, it adds nothing of substance to the inquiry. Whether the securities transaction is a relatively small part of a larger wrongdoing or is the very heart of the wrongdoing makes no difference. In either case, the primary concern addressed by the antifraud provisions of the federal securities laws—investor protection—is implicated.

- i. Application Principle 9: If what is being alleged is a mere breach of corporate fiduciary duties, the "in connection with" requirement is not satisfied.*

In the mismanagement cases, courts are fond of stating that the antifraud provisions of the federal securities laws are directed at the protection of investors and the integrity of the trading markets, not internal corporate mismanagement.³⁰⁸ This statement is true.³⁰⁹ However, to derive from this statement the principle that an allegation complaining about a mere breach of corporate fiduciary duties does not allege a sufficient connection between the fraud and the purchase or sale of securities is either to state a truism or to make a mistake.

The principle becomes a truism if one focuses on the word "mere." If a breach of state law fiduciary duties is the only allegation, it hardly seems worth pointing out that section 10(b) and rule 10b-5 are not implicated simply because the breach occurs in a corporation with outstanding shares of securities.

307. See *infra* note 314 and accompanying text.

308. See, e.g., *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971); *Buffo v. Graddick*, 742 F.2d 592, 596 (11th Cir. 1984); *Ketchum v. Green*, 557 F.2d 1022, 1028 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

309. The purposes behind the federal securities laws generally, and their antifraud provisions specifically, are explored elsewhere. See *Fletcher, Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1133-36.

Those who put forth the proposition may mean by it something more: that a breach of state fiduciary duty law that accompanies deception, which would be deemed “in connection with” the purchase or sale of securities, is less likely to be so deemed in a corporate breach of fiduciary duty situation. The reasoning in such a principle is misguided. If we have before us a case which, using appropriate principles, we deem to involve fraud in connection with a securities transaction, the connection cannot possibly be lessened by the mere presence of additional state causes of action for fiduciary duty breaches.

In the controversial part IV of the Supreme Court’s decision in *Santa Fe Industries v. Green*,³¹⁰ the Supreme Court strongly suggested that matters already covered by state corporation law are not properly within the ambit of the private right of action under 10b-5.³¹¹ The private right of action is a judicial creation and therefore subject to judicial restriction in light of policy.³¹² Further, courts may deem it unnecessary to allow private rights of action where a perfectly good alternative remedy exists under state law. Nonetheless, for purposes of the “in connection with” requirement, there is no conceptual justification for ignoring a connection that would otherwise be found to exist when the fact pattern also involves a state fiduciary duty breach.³¹³

j. Application Principle 10: Transactional proximity—eyeballing the situation.

Given the lack of guidance provided by the statutory language, it is not surprising if some courts and commentators seem to despair of any ability to identify, articulate, and apply specific principles for deciphering the “in connection with” requirement. The least guiding of the limitation principles is “transactional proximity”: the requirement that the fraud and the securities transaction exist in some undefined nexus relationship within a transaction.

Typically, in cases using this principle, the court merely states that some sort of nexus is required—that the fraud and the transaction must be linked sufficiently in the same transaction. The court then

310. 430 U.S. 462 (1977).

311. *Id.* at 477-80.

312. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748-49 (1975); *DMI Furniture, Inc. v. Brown, Kraft & Co.*, 644 F. Supp. 1517, 1528 (C.D. Cal. 1986).

313. *Accord Marshel v. AFW Fabric Corp.*, 533 F.2d 1277, 1282 (2d Cir.), *reh'g en banc denied*, 533 F.2d 1309 (2d Cir.), *vacated on other grounds*, 429 U.S. 881 (1976); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 379-80 (2d Cir. 1974); *Popkin v. Bishop*, 464 F.2d 714, 718 (2d Cir. 1972); *Herpich v. Wallace*, 430 F.2d 792, 808 (5th Cir. 1970); *Rekant v. Dresser*, 425 F.2d 872, 882 (5th Cir. 1970); *Bailey v. Meister Brau, Inc.*, 320 F. Supp. 539, 543-44 (N.D. Ill. 1970); *Pettit v. American Stock Exch.*, 217 F. Supp. 21, 25 (S.D.N.Y. 1963).

decides the case without articulating other more specific principles.³¹⁴ In other words, the court "eyeballs" it. Such an approach has obvious drawbacks. First, it offers little guidance to future decision makers, although that may be the point: the judges may be making the statement that there is no extrapolation possible from case to case.

More fundamentally, such an approach almost certainly masks a more detailed thought process that the judges are not articulating. There must be *some* mental process when a judge makes the determination that a given instance of fraud is or is not in connection with a securities transaction. More reflection should make it possible for judges to articulate those thought processes so that they may be subjected to scrutiny both by the judge and by others.

In short, this principle is really an abdication of principled reasoning responsibility. It should be avoided.

k. Application Principle 11: To be "in connection with" a purchase or sale of securities, the deception must concern the merits of the security being purchased or sold or the terms of the transaction.

In 1981, in *Rubin v. United States*,³¹⁵ the Supreme Court explicitly reserved judgment on the question whether misrepresentations not pertaining to the securities themselves can give rise to an action under the antifraud provisions of the federal securities laws.³¹⁶ Courts continue to be sharply divided on the question, which is often perceived in 10b-5 cases as an inquiry concerning the "in connection with" requirement.

314. See, e.g., *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1315 (5th Cir. 1977); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 595 & n.18 (5th Cir.), cert. denied, 419 U.S. 873 (1974); *Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339, 362-63 (N.D. Ohio 1976); cf. *Buffo v. Graddick*, 742 F.2d 592, 596 (11th Cir. 1984) (degree of "proximity" between fraud and transaction is one consideration); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 98 (S.D.N.Y. 1976). "At issue here is whether the allegedly fraudulent misrepresentations and omissions were so proximately related either to a purchase or a sale, as to be actionable as 'in connection with' such a transaction." *Id.* (court then mentions causation); cf. also *Jacobs, The Role of the Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Mismanagement*, 59 CORNELL L. REV. 27, 43 (1973) (case-by-case decisionmaking necessary to determine if fraud and transaction are "too attenuated"); Note, *supra* note 251, at 496-97 (degree of proximity within the same transaction is one consideration).

315. 449 U.S. 424 (1981).

316. *Id.* at 429 n.6.

Three distinct lines of reasoning can be found in these cases. The first holds that misrepresentation is not in connection with the purchase or sale of securities unless it pertains to the securities themselves.³¹⁷ The second modifies the first, allowing a plaintiff to go forward on an allegation of misrepresentation concerning the securities themselves *or* concerning other matters closely associated with the transaction, such as the risks in purchasing on margin generally or the course of dealing in the securities transaction.³¹⁸ The third (made up primarily of pre-*Ernst/Santa Fe/Blue Chip Stamps* cases) takes an expansive view of 10b-5, and refuses to limit the type of misrepresentation that can be in connection with the purchase or sale of securities.³¹⁹

The only basis for resolving this conflict is to ask, as the court in *Bosio v. Norbay Securities, Inc.*³²⁰ suggested, whether this is the type of misrepresentation the antifraud provisions of the federal securities laws were designed to reach.³²¹ Although there are serious dangers normally inherent in interpreting texts in light of policy,³²² where the private right of action is a judicial creation and the text offers no guidance whatsoever, courts are free to tailor the application of that text to conform with broader policy concerns.³²³ This means that judging the propriety of this principle of limitation requires consideration of the next principle, into which this one collapses.

317. See, e.g., *Saxe v. E.F. Hutton & Co.*, 789 F.2d 105, 108-09 (2d Cir. 1986); *Bennett v. United States Trust Co.*, 770 F.2d 308, 313-14 (2d Cir. 1985); *Head v. Head*, 759 F.2d 1172, 1175 (4th Cir. 1985); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984); *Nevitsky v. Manufacturers Hanover Brokerage Serv.*, 654 F. Supp. 116, 119 n.12 (S.D.N.Y. 1987); *Boccicchio v. Smith Barney, Harris, Upham & Co.*, 647 F. Supp. 1426, 1430 (S.D.N.Y. 1986); *Crummere v. Smith Barney, Harris, Upham & Co.*, 624 F. Supp. 751, 755 (S.D.N.Y. 1985).

318. See, e.g., *Taylor v. First Union Corp.*, 857 F.2d 240 (4th Cir. 1988) (deception must mislead plaintiff about value of company or in investment decision generally); *In re Financial Corp. of Am. Shareholder Litig.*, 796 F.2d 1126, 1130 (9th Cir. 1986) ("in connection with" requirement not satisfied where deception did not relate to merits of securities or any risk associated with them); *Angelaastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 944 (3d Cir.) (deception may concern course of dealing), *cert. denied*, 106 S. Ct. 267 (1985); *Arrington v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 651 F.2d 615, 619 (9th Cir. 1981) (misrepresentations concerning risks of margin in declining markets is fraud in connection with purchase of securities).

319. *Sargent v. Genesco, Inc.*, 492 F.2d 750, 763 (5th Cir. 1974); *Walling v. Beverly Enter.*, 476 F.2d 393, 396 (9th Cir. 1973); *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 396-97 (2d Cir. 1967); see also T. HAZEN, *supra* note 22, § 13.6, at 119 (1985 & Supp. 1988).

320. 599 F. Supp. 1563 (E.D.N.Y. 1985).

321. *Id.* at 1567; see also *Taylor v. First Union Corp.*, 857 F.2d 240 (4th Cir. 1988) ("in connection with" requirement unsatisfied if goals of antifraud provisions not furthered).

322. See *Fletcher*, *supra* note 44.

323. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748-49 (1975); *DMI Furniture, Inc. v. Brown, Kraft & Co.*, 641 F. Supp. 1517, 1528 (C.D. Cal. 1986).

1. *Application Principle 12: The "in connection with" requirement should be deemed satisfied if, but only if, the fraud in question is of a type that implicates one of the policies behind section 10(b) and rule 10b-5.*

Although the federal securities laws have several policy motivations,³²⁴ the antifraud provisions were designed to fulfill two policy goals: protect buyers and sellers from being disappointed in their expectations about the transaction and, more systemically, protect the securities markets from a failure of confidence that might result from a perception of unfairness.³²⁵ In categories 1 through 4 and 6, only the first policy is implicated directly; the second policy is advanced in such cases only by furthering the first. In the category 5 misappropriation cases, however, the second policy is arguably implicated directly, while the first is arguably not implicated at all. For these reasons, category 5 cases must be treated differently with respect to this principle than the others.

Because in categories 1 through 4 and 6 the touchstone is the protection of buyers' and sellers' expectations, when examining the alleged misrepresentation, a court should ask: does the complaint allege that due to deception by the defendant, the expectations of the other party regarding the securities transaction were disappointed? A further inquiry may be made as to whether each party received what he expected from the securities transaction. Under such an analysis, limiting the misrepresentations to the merits of the security involved is too harsh. There are other investment expectations that may be disappointed—for example, expectations about the risk of a portfolio generally, or the way in which the transaction will be carried out. Conversely, those cases that do not limit their analysis to upholding expectations about the securities transaction go too far.

The misappropriation cases, however, raise different concerns. Because the deception in such cases is not directed at the party with whom the defendant trades, the "uphold expectations" policy arguably does not apply. Courts may, with more analysis than they generally undertake, determine that all investors have a legitimate expectation that a rough parity of access to information will exist in

324. The purposes behind the federal securities laws are discussed more fully in Fletcher, *supra* note 309, at 1133-36.

325. See *id.*; accord *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 300 F. Supp. 1083, 1101 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd on other grounds*, 404 U.S. 6 (1971).

the securities markets. That question, which is beyond the scope of this article, must be addressed more fully, however, before the “uphold expectations” policy can legitimately be applied in misappropriation cases. Certainly Congress has not articulated clearly a view that all investors should have equal access to information, and the matter is one of controversy in the literature.³²⁶ It is unclear to what extent, if any, a disparity of access to information is unfair or harms investors. Before the “uphold expectations” rationale can be used in the misappropriation cases, the theoretical underpinnings should be explored more fully.

The same is true of the other motivating principle for the antifraud provisions: the protection of the integrity of the markets. Before a court may legitimately find that the misappropriation theory furthers the policy by proscribing acts that injure the integrity of the markets, the court should first resolve a question that is hotly debated: is the market somehow harmed when someone uses an illegitimately obtained informational advantage to trade? Again, before the policy is used as a basis for the misappropriation theory, courts should be prepared to explore the theoretical underpinnings more fully than they do.

B. Matching Principles and Categories

Having looked at the various categories and having examined the many principles that may be used therein, a return to the categories is appropriate to resolve the question as to which considerations (*i.e.*, principles) should guide a court in each type of case? Not surprisingly, given the discussion above, different categories often require different analyses.

1. Category 1: The Paradigmatic Face-to-Face Deception Concerning the Merits of a Security

The “in connection with” requirement has never been problematic for courts examining category 1 cases. *Why* such cases always satisfy the “in connection with” requirement can be answered by the fact that many of the restricting principles are satisfied in these cases. The purpose of the deception is to cause the transaction to go through,³²⁷ and it does cause the transaction to go through.³²⁸ The principle of temporal sequencing³²⁹ is satisfied, and the deception goes to the merits of the security being bought or sold.³³⁰ The victim

326. See, *e.g.*, Aldave, *supra* note 242, at 378-80.

327. See *supra* notes 284-93 and accompanying text.

328. See *supra* notes 294-98 and accompanying text.

329. See *supra* notes 299-300 and accompanying text.

330. See *supra* notes 315-23 and accompanying text.

is disappointed in his expectations concerning the transaction by being deprived through deception of that which he expected to receive. Finally, the policies of the antifraud provisions are specifically aimed at this type of transaction.³³¹

2. Category 2: Misrepresentations by Issuers Who Are Not Themselves Buyers or Sellers of Securities in the Transaction

Because no person should be liable under 10b-5 unless he is either an actual purchaser or seller or can be held liable under one of the collateral theories (*e.g.*, aiding and abetting),³³² non-trading corporate issuers should not be subjected to liability at all except under one of the collateral theories. But if courts persist to open such parties to liability, certain application principles pertain. Causation alone is insufficient and must be accompanied by an intent to cause investors to alter their investment decisions on the basis of the deception.³³³ Even then, because of the policies supporting the antifraud provisions, the defendant should not be liable except where the victim is caused to be disappointed in his expectations regarding the securities transaction.³³⁴

3. Category 3: Third Parties Who are Not Buyers or Sellers of Securities

All the principles applicable in category 2 cases are equally applicable in category 3 cases.

4. Category 4: The Mismanagement Cases

The principles of category 2 are also fully applicable in category 4 cases, but courts should be sensitive regarding two principles that are tempting but which should not be used. First, as pointed out above, the statement that "mere corporate mismanagement does not implicate Rule 10b-5" is dangerous.³³⁵ It is either a truism or is false. In either case, courts should not use it. Second, courts should eschew the principle suggesting that intervening steps militate against finding the requisite connection.³³⁶

331. See *supra* notes 324-25 and accompanying text.

332. See *supra* notes 270-72 and accompanying text.

333. See *supra* notes 284-98 and accompanying text.

334. See *supra* notes 324-26 and accompanying text.

335. See *supra* notes 309-13 and accompanying text.

336. See *supra* notes 303-04 and accompanying text.

5. Category 5: The Misappropriation Cases

This category is, without doubt, the most vexing of the group. The causation principle, which in other categories is a necessary condition, is of no use in the misappropriation cases.³³⁷ The purpose/intent rationale is useful—indeed used—but flawed and should be eschewed.³³⁸ Application of the “in connection with” requirement to misappropriation cases turns on how one perceives the policies of trader protection and market integrity to play out in the misappropriation contexts. Courts should not jump to hasty conclusions concerning those policies. Rather, they should contribute to the huge (and growing) volume of scholarly literature on the question: is there any harm or unfairness in someone trading on the basis of ill-gotten, material, non-public information? Until that question is resolved, the misappropriation theory lacks sufficient theoretical underpinnings to support it.

6. Category 6: The Conversion Cases

As noted above, in those cases in which securities are converted by the defendant and later sold, the intent/purpose principle is of no use; from the victim’s point of view, the intent or purpose of the defendant’s act is wholly fortuitous.³³⁹ Causation is not present; the conversion “causes” the later trade only in the very weak sense that necessary preparation for any event causes the event itself.³⁴⁰ With no deception concerning the purchase/sale transaction (*i.e.*, the victim cannot claim that he was disappointed in his expectations concerning that transaction, since the victim had no expectation about the transaction at all) and no impact on the policies behind the antifraud provisions (protection of buyers and sellers and protection of trading markets),³⁴¹ such conversion cases should never be deemed to involve a deception in connection with the purchase or sale of securities. The victim was deceived, but the deception is a matter of state conversion law. The mere presence of securities should not implicate the antifraud provisions of the federal securities laws.

VI. CONCLUSION

This article has attempted to sort through an intricately detailed body of law to replace complete chaos with some order. At one level, the topic of the article has been extremely narrow: the article has been concerned with one particular clause from one administrative

337. See *supra* notes 235-37, 295-96 and accompanying text.

338. See *supra* notes 292-93 and accompanying text.

339. See *supra* notes 245-47 and accompanying text.

340. See *supra* notes 245-47 and accompanying text.

341. See *supra* notes 324-25 and accompanying text.

rule promulgated under authority granted in one subsection of one of the federal securities statutes. But on another level, the topic of this article has been much broader: What should a court do when faced with a statutory standard that offers nearly no guidance as to its application? Legislative history is sometimes helpful, but sometimes it is nonexistent. Even where it does exist, the limited original purposes for which the statute was enacted may have been long overcome by a jurisprudence whose substance is only formally related to the text. Perhaps the methodology used here will be of help in deciphering other legal texts that seem incomprehensible.

Such situations cry out for a legislative solution. With the "in connection with" requirement, Congress and the SEC have unfortunately abdicated their legislative function to the courts. This should be remedied. Congress must address the law of insider trading in a coherent and comprehensive manner after full exposition of the policy concerns implicated. Congress should also make clear the relationship between federal securities fraud and deception undertaken by corporations and their officers and directors. Ambiguity breeds uncertainty, and uncertainty entails costs for the processes of capital formation. Uncertainty also creates unfairness for defendants, who (particularly in a criminal statute) should know in advance whether what they do can result in federal securities law violations. As two commentators recently suggested: "[E]ven a casual concern for the presentation of civil liberties and due process compels the conclusion that persons accused of criminal offenses should be given ample notice of precisely what conduct will rise to the sanctions that flow from them."³⁴² Congress, not the courts, should be dictating what is meant by the proscription of fraud in connection with the purchase or sale of securities.

342. Pitt & Shapiro, *The Revised Insider Trading Proscriptions Act of 1988: A Legislative Remedy for a Problem that Persists*, 26 AM. CRIM. L. REV. 7, 8 (1988).

