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The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

Subject: *Securities Fraud Liability of Secondary Actors*

Since the 1930s, publicly traded companies that commit fraud in the issuance or sale of their securities have been liable to private investors under the U.S. securities laws, as well as subject to government enforcement of these laws. Entities commonly referred to as "secondary actors"—such as banks, brokers, accountants, and lawyers, who play important but generally lesser roles in securities transactions[1]—may also be liable to investors and to the government for certain securities law violations, but as of 1994, such entities are liable only to the government, not to investors, for substantially assisting—or "aiding and abetting"—securities fraud under section 10(b) of the Securities Exchange Act of 1934 (1934 Act).[2] Before 1994, courts had interpreted section 10(b), as implemented by the Securities and Exchange Commission's (the

[1] In general, "secondary actors" are persons charged with "secondary liability" because they do not directly commit violations of the anti-fraud provisions but instead are alleged to provide substantial assistance to fraudulent conduct. Because transactions subject to the federal securities laws are often complex and involve multiple entities, it can be difficult to determine, at the time a violation occurs, who should be subject to primary versus secondary liability. In this report, we use the term "secondary actor" to refer to parties providing services to, or involved in transactions with, corporate issuers.

[2] 15 U.S.C. § 78j(b).

SEC) Rule 10b-5,[3] as implicitly authorizing investors to file aiding and abetting lawsuits even though the 1934 Act did not expressly authorize it.[4] The courts found that Congress had created an "implied private cause of action" under section 10(b). In the landmark 1994 decision *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[5] however, the U.S. Supreme Court clarified that section 10(b) and Rule 10b-5 do not create an implied private cause of action for aiding and abetting, a determination the Court reaffirmed in its 2008 decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc*[6] and its 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*.[7] Congress took action in the wake of *Central Bank* as well; in 1995, it enacted the Private Securities Litigation Reform Act,[8] giving the SEC express authority to seek enforcement against aiders and abettors of securities fraud, but imposing additional procedural restrictions on the filing of private securities fraud class action lawsuits—one of the primary vehicles by which investors seek redress.

Although the Supreme Court's decisions in *Central Bank*, *Stoneridge*, *Janus*, and other recent cases have established the contours of liability under section 10(b) as the statute is currently written, debate continues over what the appropriate scope of liability should be. As the Supreme Court noted in *Central Bank*, "[t]he issue . . . is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute."[9] In response, legislation has been introduced to amend the 1934 Act, most recently in 2010, to establish an express private right of action for aiding and abetting violations of the federal securities laws.[10] Proponents of the legislation have argued that creating such private liability could have a number of potentially positive implications for investors, the U.S. capital markets, and public companies, while opponents have argued that creating such liability could have the opposite effect.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or the Act)[11] requires GAO to analyze the impact of creating a private right of action for aiding and abetting securities law violations, including describing the factual and legal background against which creation

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[3] 17 C.F.R. § 240.10b-5.

[4] *See, e.g.*, *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966).

[5] 511 U.S. 164 (1994).

[6] 552 U.S. 148 (2008).

[7] 131 S. Ct. 2296 (2011).

[8] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of titles 15 & 18 of the U.S. Code).

[9] 511 U.S. at 177.

[10] *See, e.g.*, H.R. 5042, 111th Cong. (2010).

[11] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of titles 12 & 15 of the U.S. Code).

of such authority would be considered. This analysis responds to that mandate.[12]

We conducted our work from August 2010 through July 2011 in accordance with GAO's quality assurance framework relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient, appropriate evidence and legal support to meet our stated objectives. We believe that the information we obtained and the analysis we conducted provide a reasonable basis for any findings and judgments in this product. A more detailed description of our scope and methodology is included in Enclosure I.

<u>SUMMARY</u>

Following the stock market crash of 1929 and the ensuing Great Depression, Congress enacted two statutes that established the fundamental securities regulatory framework in place today. The Securities Act of 1933 (1933 Act) regulates public offerings of securities, while the Securities Exchange Act of 1934 (1934 Act) regulates trading in securities after they have been issued.[13] These laws require companies that issue securities to disclose specific information both before the security is first issued and periodically thereafter, to enable investors to make informed investment decisions.

The securities laws also include a number of remedies for investors who are injured by violations of the laws. The most prominent of these is section 10(b) of the 1934 Act, implemented by SEC Rule 10b-5,[14] which prohibits material misrepresentations or omissions and fraudulent conduct and provides a general anti-fraud remedy for purchasers and sellers of securities.[15] Starting in

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[12] Specifically, section 929Z of the Act directs GAO to study the impact of authorizing a private right of action against any person who aids or abets another in violation of the securities laws, and identifies areas to be included in the study if practicable. This analysis addresses all of those areas. Part I of the analysis provides an overview of the general anti-fraud prohibitions of section 10(b) and Rule 10b-5 and identifies the elements that private investors must show to prove a case for securities fraud. Part II discusses the roles that secondary actors, including accountants, attorneys, and underwriters, play in securities transactions. Part III reviews significant legislative and case law developments over the past two decades affecting secondary actors' liability for securities fraud. Part IV discusses other legal avenues for pursuing secondary actors and compensating investors. Part V sets out current standards for secondary actor liability in light of these developments. Finally, Part VI identifies recent proposals to create a private cause of action for aiding and abetting securities fraud, describes arguments that have been advanced in favor of and against such proposals, and discusses steps that have been identified, if such a right were created, to mitigate potential concerns that have been raised with creating such liability.

[13] Securities Act of 1933, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a *et seq.*); Securities Exchange Act of 1934, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a *et seq.*).

[14] 17 C.F.R. § 240.10b-5.

[15] Section 10(b) of the 1934 Act makes it unlawful "to use or employ [by the use of any means or instrumentality of interstate commerce], in connection with the purchase or sale of any

the 1940s, federal courts determined that even though section 10(b) did not expressly authorize private investors and sellers to sue under section 10(b) and Rule 10b-5, there was an "implied private cause of action" to do so based on what the courts found to be congressional intent to ensure maximum enforcement. Using this implied cause of action, investors sued both the parties who carried out the fraud—using a theory of primary liability—and those who assisted, or aided and abetted, the fraud—using a theory of secondary liability. Service providers that customarily assist companies with securities transactions were included in this category of secondary liability and became known as "secondary actors." Secondary actors can include accountants, attorneys, underwriters, credit rating agencies, securities analysts, and others. Some of these secondary actors have been characterized as "gatekeepers" because they allegedly serve as intermediaries between investors and issuers of securities and verify or certify the accuracy of corporate disclosure or have the ability to use their special status to influence the behavior of companies and thus prevent wrongdoing. At least some of these alleged gatekeepers vigorously disagree that they serve, or should serve, such a function.

In order to bring a successful case for securities fraud, a private party must prove six basic elements. These elements have been developed by the courts over the years, and some aspects have been affected by the requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA).[16] The elements are: (1) a material misrepresentation or omission; (2) fraudulent conduct "in connection with" the purchase or sale of a security; (3) a wrongful state of mind, known as "scienter," when making the misrepresentation or omission; (4) reliance upon the fraudulent conduct; (5) measurable monetary damages; and (6) a causal connection between the misrepresentation or omission and the economic loss. Each of these elements has been extensively interpreted by the courts, and because these elements are not defined by statute, court decisions continue to shape how they are applied.

The ability of investors to sue for aiding and abetting securities fraud (as distinct from a direct suit for securities fraud) changed in 1994. In *Central Bank*, the Supreme Court clarified that section 10(b) does not establish a private cause of action for aiding and abetting. Relying on the language of the statute, the Court found that Congress had not, expressly or even by implication, created a private cause of action for aiding and abetting. The Court reasoned that the requisite securities fraud element of investor reliance is not present where a party aids or abets a fraud, because the aider and abettor's conduct is not known to, and thus cannot be relied upon by,

security . . . 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(b).

[16] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of titles 15 & 18 of the U.S. Code).

investors. The Court emphasized, however, that while there is no private cause of action for aiding and abetting, secondary actors may still be primarily liable for securities fraud if they themselves commit all of the elements listed above.

Lawsuits alleging securities fraud are often brought as class actions. Class actions are well-suited to securities litigation because they enable a number of shareholders to combine claims that they could not afford to litigate individually. In PSLRA, Congress targeted what it identified as abuses in class action securities fraud litigation by imposing additional procedural restrictions on the filing of such lawsuits, designed to help weed out weaker cases at an earlier stage in the proceedings.[17] Two particularly important PSLRA reforms for Rule 10b-5 actions are a heightened requirement for alleging the scienter element and the codification of the element of loss causation. The Supreme Court has decided cases involving both of these reforms. PSLRA also gave the SEC specific authority to pursue cases against aiders and abettors of securities fraud.

After the Supreme Court struck down aiding and abetting liability in *Central Bank*, courts continued to address the question of *primary* liability for secondary actors. In 2008, the Supreme Court reaffirmed its *Central Bank* decision in *Stoneridge*. The Court determined in *Stoneridge* that secondary actors—in this case customers and suppliers—who were part of a "scheme to defraud" were not primarily liable under Rule 10b-5 because investors had not relied on their fraudulent conduct. As it had in *Central Bank*, the Supreme Court again emphasized the requisite element of investor reliance in ruling that the secondary actors were not liable to investors. The Court ruled that it was not sufficient that an entity participate in a scheme to defraud; rather, the investor must show he actually relied on the secondary actor's conduct or participation. Since *Stoneridge*, courts have addressed whether secondary actors may be held liable for substantial participation in the preparation of fraudulent statements, or whether the statements must actually be attributed to the secondary actor for liability to arise. In June 2011, the Supreme Court ruled in the *Janus* case that an investment adviser cannot be held liable for mere participation in the drafting and dissemination of false and misleading prospectuses issued by its client; the Court found that the client, not the adviser, "made" the fraudulent statement, and thus the adviser was not liable.[18] It remains to be seen how the lower courts will implement this latest Supreme Court decision.

Arguments for and against creating a private right of action for aiding and abetting relate to concerns frequently expressed about class action securities litigation: whether it successfully and efficiently deters securities fraud and whether it adequately and fairly compensates investors who are the victims of

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[17] H.R. REP. NO. 104-369, at 31-32, 37-41 (1995) (Conf. Rep.).

[18] 131 S. Ct. 2296 (2011).

fraud. Proponents of creating a private right of action argue that it is necessary to compensate investors and effectively would deter securities fraud. Opponents maintain that the current system of enforcement by the government already adequately compensates investors and deters fraud. Opponents also argue that creating a private right of action would expand the number of class action securities lawsuits, thus harming the competitiveness of the U.S. securities markets. In response, proponents argue that the reforms enacted in PSLRA are sufficient to guard against non-meritorious litigation.

ANALYSIS

PART I. OVERVIEW OF SECTION 10(b) AND RULE 10b-5 ANTI-FRAUD PROVISIONS AND ELEMENTS OF A PRIVATE CAUSE OF ACTION FOR SECURITIES FRAUD

A. History of the Private 10b-5 Cause of Action through the Mid-1990s

In the wake of the 1929 stock market crash and the ensuing Great Depression, Congress enacted two statutes that established the fundamental federal securities regulatory framework in place today. The 1933 Act regulates public offerings of securities, while the 1934 Act regulates trading in securities after they have been issued.[19] As the Supreme Court has explained, together, these acts "embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*."[20] Both statutes require disclosure of certain types of information and prohibit fraudulent or deceptive practices in particular circumstances.

In addition, the 1934 Act contains a broad anti-fraud prohibition, section 10(b). Under section 10(b), it is:

> "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . . [to] use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors."[21]

To implement section 10(b), in 1942, the SEC promulgated Rule 10b-5, which has become a critical component of the overall securities regulatory scheme.

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[19] Securities Act of 1933, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a *et seq.*); Securities Exchange Act of 1934, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a *et seq.*).

[20] *Central Bank of Denver*, 511 U.S. at 171 (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972)).

[21] 15 U.S.C. § 78j(b).

Rule 10b-5 prohibits the direct or indirect use of any means of interstate commerce to engage in certain wrongful conduct in connection with the purchase or sale of any security. Specifically, Rule 10b-5 makes it unlawful, among other things:

> "(a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[22]

B. Proving Securities Fraud under Rule 10b-5

As detailed below, to be successful in a 10b-5 private cause of action for primary liability for securities fraud, a plaintiff must allege, and ultimately prove, six elements:[23] (1) material misrepresentation or omission; (2) nexus to the purchase or sale of a security; (3) scienter; (4) reliance; (5) economic loss; and (6) loss causation. If any element is not proven, the plaintiff will not recover damages. These elements also have been influenced by legislative changes enacted in 1995 in PSLRA but because they are not specifically defined by statute, court decisions continue to shape their interpretation.[24] Rule 10b-5 cases against secondary actors usually involve an allegation of a material misrepresentation where a corporation issues a materially misleading statement to the public or has failed to disclose information or remained silent about a matter about which it has a duty to disclose.

[22] 17 C.F.R. § 240.10b-5.

[23] In private civil litigation filed in federal court, the person bringing the lawsuit (the plaintiff) generally must plead (lay out in the initial complaint) just "enough facts to state a claim to relief that is plausible on its face." *Bell Atlantic v. Twombly*, 550 U.S. 544, 570 (2007). The Federal Rules of Civil Procedure provide special standards for fraud cases. The plaintiff's complaint must allege "with particularity" specific facts showing each of the elements of fraud. FED. R. CIV. P. 9(b). Additionally, the PSLRA enhanced pleading requirements for private securities cases; if the plaintiff's complaint fails to allege the necessary facts with particularity, the court can dismiss the case. If the complaint is sufficient, then, as in all civil suits, the plaintiff must prove each of the elements of his claim by a preponderance of the evidence at trial, or, if the facts are not in dispute, in motions filed with the court.

[24] *See*, *e.g.*, *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011); *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

Six Elements of a 10b-5 Private Cause of Action

1. Material misrepresentation or omission. The defendant must have committed fraud or deceit, generally as a material misrepresentation or omission.[25] A "material" misrepresentation or omission is one that affects a reasonable investor's purchase decision.[26] Courts have held that Rule 10b-5 does not itself impose a duty to disclose, meaning that nondisclosure without an independent duty will not establish a Rule 10b-5 violation.[27] However, if a company makes a statement, there may be a further duty to correct or update the information that was disseminated.[28] Additionally, a company can be held liable for statements considered to be half-truths—statements that are literally themselves true, but omit some other material fact that would be necessary to make the statement as a whole not misleading.[29]

2. Nexus. The defendant's fraudulent conduct must meet the "nexus" requirement, meaning that the conduct must have been "in connection with the purchase or sale" of a security in interstate commerce.[30] The Supreme Court in *Blue Chip Stamps* held that under the language of section 10(b)—making it "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 such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors"[31]—only those who actually purchased or sold securities have an implied private right of action under Rule 10b-5, not those who decided *not* to purchase or sell a security based on fraudulent conduct.[32] This part of the nexus element is known as the purchaser/seller requirement.

3. Scienter. The defendant must have "scienter." That is, the defendant must have performed the conduct at issue with a wrongful state of mind. The plaintiff must prove that the defendant intended "to deceive, manipulate, or defraud."[33] To meet this standard of "mental fault," a plaintiff must allege and

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[25] 17 C.F.R. § 240.10b-5.

[26] *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988). In a recent case, *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), the Supreme Court addressed how a plaintiff would plead the materiality of adverse events associated with a pharmaceutical company's products.

[27] *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1321-22 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988)).

[28] THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, § 12.17 (West Group 2005).

[29] *See, e.g.*, Donald C. Langevoort, *Half-truths: Protecting Mistaken Inferences by Investors and Others*, 52 STAN. L. REV. 87, 88 (1999).

[30] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 768 (1975) (citing 17 C.F.R. § 240.10b-5).

[31] 15 U.S.C. § 78j(b).

[32] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 746-47 (1975).

[33] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

prove more than negligence, *i.e.*, more than a failure to exercise the standard of care that a reasonable person would exercise under the circumstances. Rather, Rule 10b-5 liability requires the defendant to have acted knowingly or recklessly. Under the "knowing" standard, the defendant either knew or consciously disregarded the fact that the results of his conduct were reasonably certain to occur. Under the "reckless" standard, the defendant must have made a statement with a deliberate disregard of a known risk of misleading investors that is either known to the speaker or so obvious the speaker must have known of it.[34] Although many federal appellate courts have found that reckless behavior satisfies the scienter requirement in Rule 10b-5 cases, courts have differed on the degree of recklessness required.[35]

4. Reliance. The plaintiff must have relied upon the defendant's fraudulent conduct when entering into the transaction at issue. In other words, the defendant's fraudulent misrepresentation or omission must have affected the plaintiff's decision to purchase or otherwise enter into the transaction. In certain circumstances, the plaintiff can qualify for a rebuttable presumption of reliance, which reverses the burden and requires the defendant to *disprove* this presumption. The first circumstance in which a plaintiff is entitled to a rebuttable presumption of reliance is where the defendant had a duty to disclose to the plaintiff and made a material *omission*.[36] In a face-to-face transaction between seller and purchaser during which the defendant seller failed to state material facts, the plaintiff's reliance can be presumed from the materiality of the omissions. That is, if the facts omitted would have been important (*i.e.*, material) to an individual's decision to purchase, reliance by the plaintiff on the defendant's omission can be presumed. The second rebuttable presumption circumstance involves the fraud-on-the-market doctrine, where proof of actual reliance is not necessary in a class action against public companies.[37] The fraud-on-the-market presumption applies if the information at issue is material, the market is sufficiently active, and the misinformation was disseminated publicly.[38] Essentially, reliance is presumed

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[34] *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977). The Seventh Circuit states that "[r]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* (citing *Franke v. Midwestern Okla. Dev. Auth.*, 428 F.Supp. 719 (W.D. Okla. 1987)).

[35] *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007). The Supreme Court has not yet determined whether reckless conduct is sufficient to satisfy the scienter requirement.

[36] *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-53 (1972).

[37] *Basic, Inc. v. Levinson*, 485 U.S. 224, 246-47 (1988). In 1968, the Second Circuit Court of Appeals laid the groundwork for the fraud-on-the-market doctrine by determining that privity was not a requirement for Rule 10b-5 liability. Thus, parties other than the issuer could be held liable. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005(1971).

[38] *Id.*

when the statements at issue become public and the public information is reflected in the market price of the publicly traded security. By assuming an accurate share price, the shareholders "relied" on the misstatement, so it is not necessary to prove actual, individual reliance.

5. Economic loss. The plaintiff must have suffered measurable monetary damages for which he seeks recovery. As with the common law tort of fraud, such damages must constitute an actual economic loss, and not merely nominal or trivial damages. This element also requires the plaintiff to have already suffered the economic loss; he cannot merely expect a loss in the future.

6. Loss causation. There must be a causal connection between the defendant's material misrepresentation or omission and the plaintiff's economic loss. That is, the plaintiff's loss must not only be related to the defendant's fraudulent misrepresentation or omission, but actually *caused* by it.[39]

In the 1940s, lower level federal courts first interpreted section 10(b) and Rule 10b-5 as creating an implied private right of action by purchasers and sellers of securities injured by securities fraud.[40] Over the decades, federal appellate courts and eventually the U.S. Supreme Court agreed, interpreting the statute broadly and flexibly in light of its remedial purpose and well-developed common law fraud principles.[41] While a private cause of action under Rule 10b-5 still exists today, its breadth has been narrowed substantially in the last two decades by the Supreme Court's clarification in the 1994 *Central Bank* case that Congress did not intend to create a private cause of action for aiding and abetting under section 10(b).[42] Additionally, while the law governing the private right of action under section 10(b) was shaped solely by court decisions for decades, in 1995, Congress recognized the implied private right of action (for primary violations) but imposed new procedural requirements for private primary liability securities fraud class actions.[43]

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[39] *See* 15 U.S.C. § 78u-4(b)(4); *see also Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 338 (2005).

[40] *See, e.g.*, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). An implied private cause of action exists where Congress did not include an explicit private right of action in a law, but courts read a provision to mean that Congress intended there to be a remedy in order to ensure the provision is enforced.

[41] *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13, n.9 (1971).

[42] 511 U.S. 164 (1994).

[43] Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of titles 15 & 18 of the U.S. Code).

PART II. THE ROLES OF SECONDARY ACTORS IN SECURITIES TRANSACTIONS

A number of "primary" and "secondary" parties are typically involved in securities transactions both during the issuance process and after the public offering is complete. First and foremost is the securities issuer, which must comply with specific statutory and regulatory requirements to disclose information and inform investors. The issuer and its executives may commit securities fraud by failing to comply with those requirements by making deceptive statements or through participating in fraudulent schemes. Other entities may then assist or cooperate with the issuer. Commentators have asserted that at least some of these secondary actors are "gatekeepers"[44] who serve as intermediaries between issuers and investors, but some of the secondary actors disagree that they serve this role.[45] In some cases, the intermediary is responsible for determining the accuracy of a company's statements about itself, or about a transaction, as well as for assessing the merits of an offering or other transaction. The gatekeeper may assure the accuracy of corporate disclosures in connection with securities offerings, thus addressing the problem of information asymmetry between issuers and investors.[46] For example, a credit rating agency assesses a company's ability to repay long-term debts; an accountant audits a company's financial statements; and a securities analyst measures a company's prospects in the marketplace. In some cases the gatekeeper's role is legally mandated. Some commentators have argued that a gatekeeper may be able to deter corporate clients from engaging in fraudulent practices by influencing the behavior of the client.[47] Finally, in some cases, plaintiffs may allege that commercial partners of issuers are involved in fraudulent transactions.

A. Accountants

Public accountants perform a broad range of accounting, auditing, tax, and consulting activities for their clients.[48] The practice of accounting is regulated by the applicable board of accountancy of each state, the District of Columbia, or U.S. territory in which an accountant practices, as well as the rules and

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[44] *See*, *e.g.*, JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (Oxford Univ. Press 2006).

[45] *See Report of the New York City Bar Association Task Force on the Lawyer's Role in Corporate Governance—November 2006*, 62 BUS. LAW. 427 (2007).

[46] *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308-09 (2004).

[47] Reiner H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L. J. 857, 888-96 (1984).

[48] BUREAU OF LABOR STATISTICS, OCCUPATIONAL OUTLOOK HANDBOOK, 2010-11 EDITION: ACCOUNTANTS AND AUDITORS (2010), *available at* http://www.bls.gov/oco/ocos001.htm; *see also* AICPA, FAQs—Become a CPA, http://www.aicpa.org/BecomeACPA/FAQs/Pages/FAQs.aspx (last visited July 19, 2011).

codes of conduct of professional associations to which the accountant belongs, such as the American Institute of Certified Public Accountants (AICPA).[49] In that regard, each regulatory jurisdiction defines what constitutes "public accounting" and who qualifies as a "certified public accountant" or "CPA" under their regulatory authorities.[50] Subject to applicable requirements of each licensing jurisdiction, public accountants may provide services as individuals or firms to clients, including public companies, or to their employers, if they are employed in-house by a public company.[51] In this regard, public accountants can serve public companies as part of management (*i.e.*, as employees), as contracted consultants (*i.e.*, as vendors of professional services), or as independent certified public accounting service providers.

Certified public accountants can serve as external auditors of public companies. Federal securities laws require that public companies have the financial statements that they prepare upon initial registration and annually thereafter audited by a certified public accountant. To obtain an audit, the audit committee of the public company's board of directors engages an external auditor from among the independent public accountants who are registered with and regulated by the Public Company Accounting Oversight Board (PCAOB).[52] The audit must be conducted in accordance with the auditing standards promulgated by PCAOB,[53] which require auditors to plan and perform the audit to obtain reasonable assurance of whether the financial statements are free of material misstatement (whether caused by error or fraud) and, for public companies with market capitalization in excess of $75 million, whether effective internal control over financial reporting was

[49] AICPA, CODE OF PROFESSIONAL CONDUCT (2010), *available at* http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx.

[50] For example, the Code of Virginia defines "the practice of public accounting" as "the giving of an assurance" other than under certain circumstances, VA. CODE ANN. § 54.1-4400, and it generally prohibits the practice of public accounting or the use of the title "Certified Public Accountant" unless licensed by the Virginia Board of Accountancy, VA. CODE ANN. § 54.1-4414.

[51] According to AICPA, all 55 public accounting licensing jurisdictions require prospective public accountants to pass the Uniform CPA Examination as a condition of licensure. The AICPA is responsible for content development and scoring of the CPA Exam. *See* AICPA, Examination Overview, http://www.aicpa.org/BECOMEACPA/CPAEXAM/EXAMOVERVIEW/Pages/default.aspx (last visited July 19, 2011).

[52] PCAOB was established by the Sarbanes-Oxley Act of 2002 to oversee the audit of public companies subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies whose securities are sold to, and held by and for, public investors. 15 U.S.C. § 7211. PCAOB Rule 2100 requires each domestic or foreign firm to register with PCAOB if it prepares or issues any audit report with respect to an issuer or plays a substantial role in the preparation or issuance of such audit reports. Registered public accountants are subject to periodic inspection by PCAOB and investigation and disciplinary action by PCAOB for noncompliance with the Sarbanes-Oxley Act, the rules of PCAOB and the SEC, and other laws, rules, and professional auditing standards governing the audits of public companies, brokers, and dealers. PCAOB Rules 4000, 5000.

[53] PCAOB, STANDARDS, *available at* http://pcaobus.org/Standards/Pages/default.aspx.

maintained as of the balance sheet date in all material respects.[54] The objective of the financial statement audit[55] is for the external auditor to reach an opinion on the fairness in which the financial statements of the company present, in all material respects, the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. In connection with the financial statement audit, the PCAOB auditing standards require auditors to review information reported outside the financial statements and consider whether such information or the manner in which it is presented is materially inconsistent with the audited information in the financial statements. External auditors may also perform work related to other public company financial reports, such as compiling financial reports and reviewing quarterly financial statements and other reports for the public company, subject to the applicable accounting standards.

B. Attorneys

Attorneys play important roles in securities transactions. These can include assisting corporate clients with various types of securities transactions, such as private placements, public offerings of securities, and other corporate transactions. Attorneys also are often involved in preparing disclosure documents, advising on disclosure issues, and representing clients in formal proceedings. Attorneys also may represent securities professionals, such as underwriters and broker-dealers in connection with raising capital for corporate clients. In addition, attorneys may give advice concerning the application of the law to specific transactions and on periodic reports to shareholders and the SEC or public statements made by corporate executives.

In many cases, attorneys may provide written legal opinions to advise corporate clients on the best method of carrying out transactions. They may also provide opinions to issuers in connection with securities registration or the validity of a securities issuance. In some cases, attorneys for the issuer or other parties associated with a public offering may provide opinions to assure the parties that certain legal conditions necessary to the closing of the offering have been met.[56] Counsel generally reviews the veracity and completeness of registration materials and attempts to ensure that a thorough investigation of the issuer is made.[57]

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[54] *See also* SEC Regulation S-X, Art. 2, 17 C.F.R. § 210.2-02.

[55] *See* PCAOB, Statement on Auditing Standards No. 1, AU § 110.01.

[56] Ass'n of the Bar of the City of N.Y., *Report of the Special Committee on Lawyers' Role in Securities Transactions*, 32 BUS. LAW. 1879, 1884-86 (1977).

[57] The rules and ethical considerations of the Model Rules of Professional Conduct and the Model Code of Professional Responsibility of the American Bar Association address the duties of attorneys in a range of contexts. The Model Rules and/or Model Codes are adopted in some form by most individual states, and depending on the details of a particular state's rules, would apply to attorney conduct in the context of securities-related transactions. For example, attorneys have an obligation to be properly prepared, accept only those matters they are competent to handle, and, in rendering opinions and disclosure advice, diligently represent

C. Investment Banks

Investment bank activities may include merger and acquisition services, underwriting, asset management and other securities services as well as trading and principal investments. They may act as trading counterparties to other companies or provide financing as commercial lenders. [58] In addition, investment banks may provide advisory services to other companies in connection with structuring transactions. As noted below, securities analysts may be employed by or otherwise affiliated with investment banks. As underwriters, investment banks assist companies that are registering their securities offerings under the 1933 Act with sales of their securities. The underwriter acts as an intermediary between the issuer and the investor and assists with pricing the offering and structuring financing. Most commonly, the company will enter into a negotiated underwriting agreement with an investment banker or group of investment bankers. The underwriter and the issuer prepare the registration statement. The underwriters usually are broker-dealers who are members of the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization that oversees broker-dealers, and the underwriting agreements are subject to the rules that FINRA publishes. FINRA also sets standards for and reviews underwriters' compensation.[59]

The most common underwriting arrangement is the firm-commitment underwriting in which the issuer sells the allotment of shares outright to a group of securities firms.[60] The securities firms are represented by managers, managing underwriters or principal underwriters, who sign the agreement and then contact other broker-dealers to become members of the underwriting group and act as wholesalers of the securities. Underwriters undertake a substantial factual investigation of the issuer to ensure that all disclosures are accurate.

D. Credit Rating Agencies

The 1934 Act defines a credit rating as an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.[61] In the past few decades, credit ratings have assumed

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their clients. On the other hand, if a client's conduct is criminal in nature, counsel must not assist or advise the client in furthering such conduct.

[58] *See* Robert J. Rhee, *The Decline of Investment Banking: Preliminary Thoughts on the Evolution of the Industry 1996-2008*, 5 J. BUS. & TECH. L. 75 (2010).

[59] *See* FINRA Rule 5100, Securities Offerings, Underwriting and Compensation. The purpose of the review is to assure that the compensation is fair and reasonable.

[60] Other types of negotiated underwriting agreements include strict underwriting and best efforts underwriting. The strict underwriter guarantees to purchase the unsold portion of the allotment. Best efforts underwriting does not put the underwriter at risk if investors do not purchase the shares being offered to the public.

[61] 15 U.S.C. § 78c(a)(60).

increasing importance in the financial markets, in large part due to their use in law and regulation. In 1975, the SEC first used the term National Recognized Statistical Rating Organization (NRSRO) to describe those rating agencies whose ratings could be relied upon to determine capital charges for different types of debt securities broker-dealers held.[62] Since then, the SEC has used the NRSRO designation in a number of regulations. Issuers seek credit ratings for a number of reasons, such as to improve the marketability or pricing of their financial obligations, or to satisfy investors, lenders, or counterparties. Institutional investors, such as mutual funds, pension funds, and insurance companies are among the largest owners of debt securities in the United States and are substantial users of credit ratings. Retail participation in the debt markets generally takes place indirectly through these fiduciaries. Institutional investors may use credit ratings as one of several inputs to their own internal credit assessments and investment analysis. Broker-dealers that make recommendations and sell securities to their clients also use ratings.[63]

Academic literature suggests that credit ratings affect financial markets both by providing information to investors and other market participants and by their use in regulations. Studies find that obtaining a credit rating generally increases a firm's access to capital markets and that firms with credit ratings have capital structures different from those of firms without them. Some studies suggest that firms adjust their capital structure to achieve a particular credit rating. One explanation of these relationships is that credit rating agencies have access to private information about the issuers and issues they rate, and the ratings they assign incorporate this information. Thus, ratings are a mechanism for communicating this otherwise unavailable information to market participants. The appropriate role of credit rating agencies has become increasingly controversial in the wake of the recent financial crisis. The performance of the three largest NRSROs in rating subprime residential mortgage-backed securities and related securities raised questions about the accuracy of their ratings generally, the integrity of the ratings process, and investor reliance on NRSRO ratings for investment decisions.[64] The Dodd-Frank Act made a number of changes affecting rating agencies, as discussed in in Part V below.

E. <u>Securities Analysts</u>

Securities analysts, through their research and stock recommendations, play an important role in providing investors with information that may affect investment decisions. Analysts typically research the current and prospective

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[62] *See* 17 C.F.R. § 240.15c3-1.

[63] *See* GAO, SECURITIES AND EXCHANGE COMMISSION: ACTION NEEDED TO IMPROVE RATING AGENCY REGISTRATION PROGRAM AND PERFORMANCE-RELATED DISCLOSURES, GAO-10-782 (2010).

[64] *See* SEC OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, DIVISION OF TRADING AND MARKETS AND OFFICE OF ECONOMIC ANALYSIS, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (2008).

financial condition of certain publicly traded companies and make recommendations about investing in those companies' securities based on their research. This research is likely to include all publicly available information about the company and its businesses, including financial statements; research on the company, industry, product or sector; and public statements by and interviews with executives of the company and its customers and suppliers. The analysis and opinions are generally presented on a relative basis and compare companies' performance with a sector or industry. To develop judgments about the future prospects of the company and its securities, analysts may evaluate the company's expected earnings, revenue, and cash flow; operating and financial strengths and weaknesses; long-term viability; and dividend potential. They also may assess the sensitivity of their projections to cyclical factors and various types of risks, including market and credit risk. Information in analyst reports has been cited as valuable to the investing public because an investor might rely on the recommendations and analysis as helping to foster accurate pricing of securities.[65]

Analysts perform their research for different types of investors, including brokerage firm customers. Sell-side analysts (who perform research for affiliated investment banks and produce widely-disseminated reports about companies and advice to buy, sell or hold securities) are subject to oversight by securities self-regulatory organizations and the SEC.[66] Buy-side analysts (who perform research for institutional investors, such as mutual funds) produce private reports for their employers who may purchase securities for their own account or for client accounts. In contrast, independent analysts may provide research without any relationship to the firms that they cover.

PART III. SIGNIFICANT LEGISLATIVE AND COURT DEVELOPMENTS AFFECTING SECONDARY ACTOR LIABILITY FOR SECURITIES FRAUD

A. *Central Bank* Decision (1994)

Prior to 1994, federal courts held that there was an implied private right of action under Rule 10b-5 against not only primary actors, but also aiders and abettors. Lawsuits for aiding and abetting securities fraud generally could be brought by private parties in federal courts, as well as by the SEC in civil actions in federal court or in an administrative proceeding. The elements to be proved in a private aiding and abetting theory of liability were: (1) the existence of a primary violation of section 10(b) by another person; (2) some

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[65] *See*, *e.g.*, Mark A. Chen & Robert Marquez, *Regulating Securities Analysts* 23 (Working Paper, 2003), *available at* http://ssrn.com/abstract=485942.

[66] *See*, *e.g.*, SEC Regulation Analyst Certification; NASD Rule 2711; NYSE Rule 472. Sell-side analysts are subject to rules requiring them to disclose conflicts of interest and prohibiting certain conduct that would result in a conflict of interest.

level of knowledge by the aiding and abetting defendant of the primary violation (such as recklessness); and (3) substantial assistance by the aiding and abetting defendant in committing the primary violation.[67]

In 1994, the Supreme Court in *Central Bank of Denver* held that although primary actors could be held liable for securities fraud in private lawsuits, the language of the 1934 Act did not expressly or implicitly authorize private investors to sue those secondary actors alleged to have aided and abetted securities fraud.[68] In *Central Bank*, a municipal authority issued bonds to finance public improvements at a development, and the bonds were secured by liens on the property.[69] The bond covenants required that the land be worth at least 160 percent of the bonds' outstanding principal and interest.[70] Central Bank of Denver, the indenture trustee, had concerns that the property's actual value was less than the required 160 percent and considered obtaining an independent property appraisal.[71] After discussions with the municipal authority, however, Central Bank decided to postpone the appraisal; the authority then became insolvent, and bondholders sued Central Bank, alleging that the bank recklessly aided and abetted the authority's fraud.[72]

The Supreme Court found Central Bank not liable under section 10(b). The Bank had not committed any primary violation, and the statute did not, the Court ruled, expressly or even by implication, include a private right of action for aiding and abetting. The Court reasoned that the scope of section 10(b) prohibits only the actual making of a material misstatement (or omission) and does not reach aiding and abetting such a violation. The Court noted that because Congress did not include an express private cause of action for aiding and abetting anywhere in the federal securities laws, it cannot logically be inferred that Congress would have implied such a cause of action under section 10(b). Additionally, the Court concluded that when Congress wished to provide aiding and abetting liability, it did so expressly, for example, in connection with the general criminal aiding and abetting statute.[73] According to the Court, Congress's failure to mention aiding and abetting in section 10(b) indicates that such liability was not intended.

The Court in *Central Bank* also placed a heavy emphasis on reliance as a requirement for a 10b-5 action, a requirement that is by definition absent in

[67] *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 898 (10th Cir. 1992), *rev'd sub nom. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

[68] 511 U.S. 164, 191 (1994).

[69] *Id.* at 167.

[70] *Id.*

[71] *Id.* at 167-68.

[72] *Id.* at 168.

[73] *See* 18 U.S.C. § 2.

aiding and abetting actions. The Court saw reliance as essential to any Rule 10b-5 action and could not allow the plaintiff to recover in a situation where the plaintiff did not directly rely on any fraudulent statements or omissions by the defendant.[74] The plaintiff therefore could not recover damages because the defendant's conduct did not satisfy all the elements of primary liability in a private Rule 10b-5 action and could not recover under an aiding and abetting theory as such a theory was not provided by section 10(b).

Finally, the Court acknowledged various policy arguments for and against recognition of a private cause of action for aiding and abetting, but rejected the assertion that the cause of action under Rule 10b-5 should extend to aiders and abettors simply because it would ensure achievement of the statute's objectives. "The SEC [in a friend of the court brief] points to various policy arguments in support of the 10b-5 aiding and abetting cause of action," the Court noted.[75] However, "[p]olicy considerations cannot override our interpretation of the text and structure of the Act . . . The point here . . . is that it is far from clear that Congress in 1934 would have decided that the statutory purposes would be furthered by the imposition of private aider and abettor liability."[76] The Court also cited policy-based reasons for eliminating a cause of action for aiding and abetting, including large sums expended by secondary actors even before trial and the generally vexatious nature of Rule 10b-5 class action litigation.[77]

B. Private Securities Litigation Reform Act (1995)

Following *Central Bank*, Congress addressed some concerns about class action securities litigation by enacting the Private Securities Litigation Reform Act of 1995.[78] PSLRA amended the securities laws by creating new procedural requirements for instituting private actions, including Rule 10b-5 actions. PSLRA is intended to address concerns that Congress had about securities class action litigation by discouraging frivolous litigation.[79] A class action is a litigation procedure that allows a representative of a group of persons to sue on behalf of that group when the litigated issues are of common interest to a number of persons. Class actions enable members of a class, *i.e.*, shareholders, to sue even though they are geographically dispersed, and class action lawsuits enable members of the class to combine claims that they could not afford to litigate individually. Securities fraud actions typically are brought to benefit all shareholders who purchased stock during a class period in which misrepresentations about the stock have been made but not corrected.

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[74] 511 U.S. at 180.

[75] *Id.* at 188.

[76] *Id.* at 188-90.

[77] *Id.* at 189.

[78] Pub. L. No. 104-67, 109 Stat. 737 (1995).

[79] H.R. REP. NO. 104-369, at 31, 32-36, 42-47 (1995) (Conf. Rep.).

With PSLRA, Congress targeted what it identified as abuses in class action securities fraud litigation.[80] In particular, Congress was concerned that plaintiffs' attorneys pursued cases that were intended to generate large fees and settlements without regard to the best interests of shareholders and corporations. The PSLRA amendments include:

(1) Imposing additional requirements concerning whom a court can appoint as class representative in claims under both the 1933 and the 1934 Acts, with a presumption in favor of the class member with the largest financial interest in the relief sought by the class.[81] This reform was intended to increase the likelihood that institutional investors would serve as class representatives and replace the traditional approach of selecting the first plaintiff to file as the class representative.[82]

(2) Limiting attorney's fees in securities class actions to a reasonable percentage of any damages paid to the class.[83]

(3) Restricting the use of pre-trial discovery by barring discovery until after a resolution of a motion to dismiss.[84]

(4) Instituting a system of proportionate liability, as opposed to joint and several liability, for defendants in private actions that did not knowingly violate Rule 10b-5. Defendants who acted knowingly would be subject to joint and several liability.[85]

(5) Providing a so-called safe harbor for forward-looking statements. If the predicted results do not materialize, liability cannot be based on a predictive statement if the statement is identified as such and accompanied by meaningful cautionary language.[86]

PSLRA is directed primarily at concerns about class action litigation and raises the standards for certain elements that must be alleged in order to maintain an action to recover for securities fraud.[87] In filing a complaint in a Rule 10b-5

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[80] *Id.*

[81] 15 U.S.C. §§ 77z-1(a)(3)(B), 78u-4(a)(3)(B).

[82] H.R. REP. NO. 104-369, at 32-35 (1995) (Conf. Rep.).

[83] 15 U.S.C. § 78u-4(a)(6).

[84] *Id.* § 78u-4(b)(3)(B).

[85] *Id.* § 78u-4(f). If defendants are found jointly and severally liable under Rule 10b-5, the entire damage award generally can be collected from one or more of the defendants. Where proportionate liability applies, defendants are liable for only their proportionate share of the damages.

[86] *Id.* § 78u-5(c).

[87] H.R. REP. NO. 104-369, at 41 (1995) (Conf. Rep.).

case, the plaintiff must allege each of the six required elements, discussed above, and if the plaintiff fails to adequately allege any one of the elements, the claim is subject to dismissal by the court. As discussed below, PSLRA addressed three aspects of the elements of a Rule 10b-5 fraud action: the standard for describing the statements alleged to have been misleading, the standard for what must be alleged about the defendant's mental state, and the standard for proving loss causation. PSLRA's heightened pleading requirements are designed to enable courts to screen out cases that lack merit at an early stage in the proceedings, thus saving defendants the expense of defending these suits.

1. Heightened Pleading Standards

All private Rule 10b-5 actions are subject to PSLRA's heightened pleading standards that require plaintiffs to specifically assert "each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading."[88] To meet this standard, the complaint must generally include facts that show exactly why the statements were misleading, including facts about the "time, place, and content of the alleged misrepresentations."[89] The court then determines whether the complaint sufficiently states a cause of action by examining the specific factual content of the allegations made with respect to each essential element of the action. If a plaintiff fails to meet the heightened complaint standards for alleging this element, PSLRA requires the court to dismiss the case upon the defendant's motion to dismiss.[90]

2. Scienter

PSLRA created a heightened requirement in connection with scienter, the third element of the Rule 10b-5 cause of action noted previously. Under PSLRA, the complaint must "state with particularity facts giving rise to a strong inference" that the defendant acted with scienter.[91] This means that the complaint must support an inference that the defendants acted with scienter, "a mental state embracing intent to deceive, manipulate or defraud."[92] PSLRA does not, however, define what constitutes "a strong inference."

In a significant recent decision, the U.S. Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* addressed how to treat competing inferences in determining whether a complaint establishes a strong inference of scienter. The Court held that the fraud claims will survive dismissal and be decided at

[88] 15 U.S.C. § 78u-4(b)(1).

[89] *See In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 46 (1st Cir. 2005) (quoting *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 193 (1st Cir. 1999)).

[90] 15 U.S.C. § 78u-4(b)(3)(A).

[91] *Id.* § 78u-4(b)(2).

[92] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94, n.12 (1976)).

trial only if a reasonable person would find that the inference of scienter is "more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent conduct."[93] This standard requires that the lower courts, when considering a private complaint in a securities fraud action, must consider the complaint in its entirety and take into account plausible opposing inferences. First, the court must consider everything in the complaint, including documents incorporated by reference, to determine "whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, [and] not whether any individual allegation, scrutinized in isolation, meets that standard."[94] Second, the court must engage in a comparative analysis, considering not just the inferences asserted by the plaintiff but all the competing inferences put forth by the defendant that could be drawn rationally from the alleged facts.[95] At trial, the plaintiff must then prove scienter by a preponderance of the evidence, *i.e.*, the plaintiff must establish that it is "more likely than not" that the defendant acted with scienter. The Court in *Tellabs* did not determine whether recklessness was sufficient to prove scienter or whether the plaintiff must show intent to deceive, manipulate, or defraud.[96]

3. Loss Causation

PSLRA codified the element of loss causation by requiring the plaintiff to prove that the defendant's act or omission (*i.e.*, material misrepresentation or omission) actually caused the economic loss for which the plaintiff is seeking damages.[97] In many Rule 10b-5 class action lawsuits, the plaintiffs' economic loss relates to a significant drop in stock price. Therefore, the loss causation element requires the plaintiffs to allege and prove that, for example, they bought the stock at a price that was artificially inflated as a result of the defendant's misstatement or omission.[98] This means that the plaintiffs must allege and prove that there is a strong relationship between the defendant's conduct and the plaintiffs' subsequent loss.

The Supreme Court in 2005 in *Dura Pharmaceuticals v. Broudo* interpreted the loss causation requirement.[99] In that case, shareholders alleged that Dura Pharmaceuticals (Dura) made fraudulent statements about its belief of future Food and Drug Administration approval of a new medical device. The shareholders claimed that they suffered economic loss, because this

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[93] *Id.* at 314.

[94] *Id.* at 310.

[95] *Id.* at 314.

[96] In *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), the Court applied the *Tellabs* standard to find that the defendant acted with the required level of scienter.

[97] 15 U.S.C. § 78u-4(b)(4).

[98] *See* H.R. REP. NO. 104-369, at 41 (1995) (Conf. Rep.).

[99] 544 U.S. 336 (2005).

misrepresentation caused an artificial elevation in Dura's share price and after the statement was disclosed as fraudulent, the share price fell. The plaintiffs argued that their damages were based on overpayment at the time of purchase. Looking to the language of PSLRA and principles of common law tort actions for deceit and misrepresentation, the Supreme Court found that to satisfy the loss causation requirement, it is not sufficient to state that the price was inflated by the fraud, but the plaintiff must go further to show economic loss. The temporary drop in share price following the disclosure of the fraudulent statement, according to the Court, was not inevitably caused by the fraud. The fraudulent statement may have contributed to the price drop, but many other factors, including changed economic circumstances and new industry-specific or firm-specific facts, also may have contributed to or caused the drop in share price. According to the Court, it is not sufficient for the fraudulent statement to "touch upon" or relate to the economic loss; instead, the statement actually must *cause* the loss.[100] The Court determined that the plaintiff's complaint was legally insufficient and remanded the case to be decided by the lower court under the Court's interpretation of the loss causation requirement.

The requirements for successfully alleging loss causation continue to be litigated. The Supreme Court in *Dura* did not determine the appropriate pleading standard for loss causation. Courts of appeal have differed on whether the heightened pleading standard set forth in rule 9(b) of the Federal Rules of Civil Procedure or the "plausibility" standard under rule 8(a)(2) should apply.[101] Additionally, the Supreme Court recently determined in the case of *Erica P. John Fund, Inc. v. Halliburton Co.* that securities fraud plaintiffs need not prove loss causation order to obtain class certification.[102]

C. Securities Litigation Uniform Standards Act (1998) and Class Action Fairness Act (2005)

After PSLRA was enacted, some plaintiffs tried to avoid its higher standards for federal court lawsuits by suing in state court. Congress reacted to this trend by passing the Securities Litigation Uniform Standards Act of 1998

[100] *Id.* at 343 (emphasis in original).

[101] FED. R. CIV. P. 8(a)(2) requires that a plaintiff submit "a short and plain statement of the claim showing that the pleader is entitled to relief"; FED. R. CIV. P. 9(b) requires that a plaintiff "state with particularity the circumstances constituting fraud." *See* Gregory A. Markel & Martin L. Seidel, *Lower Courts Divided on Standard For Pleading Loss Causation Post-'Dura'*, 245 N.Y. L.J. 61 (2011).

[102] 131 S. Ct. 2179 (2011). In order for a class action to proceed, the court must find that "the questions of law and fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy." FED. R. CIV. P. 23(b)(3). The Fifth Circuit U.S. Court of Appeals had found that the plaintiff had to prove the separate element of loss causation in order to trigger *Basic*'s presumption of reliance. The Supreme Court determined that this requirement was not justified by the *Basic* case.

(SLUSA).[103] SLUSA provides that certain class actions with more than fifty class members involving state securities laws and class actions based on common law fraud are preempted and cannot be filed.[104] SLUSA generally applies to class actions involving publicly traded securities.[105] Immediately after the passage of SLUSA in 1998, there was some disagreement as to how far the law went in displacing class actions for securities fraud under state law. Some believed that SLUSA only applied to those initiating a lawsuit who met the purchaser/seller requirement from *Blue Chip Stamps*, discussed above. Others read SLUSA more broadly as not containing that specific limitation. The Supreme Court addressed the issue in 2006, holding that the more broad reading was appropriate and that it is not necessary for the purchaser/seller requirement to be met in order for a securities fraud action to be preempted by SLUSA.[106] The Court found this reading of SLUSA to be more consistent with Congress's goal of creating uniform procedural standards in PSLRA for bringing securities fraud lawsuits. If only a narrow subset of private securities fraud class actions were preempted by SLUSA, plaintiffs could circumvent the procedural requirements put in place in PSLRA by filing class actions outside that narrow subset in state court or in federal court under state law. In essence, the Court found that the distinction between purchasers/sellers and holders is irrelevant for the purposes of SLUSA preemption, and that class actions brought by either type of party cannot be brought under state law or in state court because they are preempted.[107]

Additionally, Congress enacted the 2005 Class Action Fairness Act (CAFA).[108] CAFA confers original federal jurisdiction over any class action with at least 100 claimants, minimal diversity,[109] and an aggregate amount in controversy of at least $5 million. Commentators have noted that SLUSA and CAFA result in state securities class actions being restricted to claims that involve corporate governance or merger and acquisition transactions that are based on the law where the defendant was incorporated, smaller class actions, and perhaps class actions based solely on 1933 Act claims.[110]

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[103] Pub. L. No. 105-353, 112 Stat. 3227 (1998).

[104] 15 U.S.C. § 78bb(f)(5)(B).

[105] *Id.* § 78bb(f)(5)(E).

[106] *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 88-89 (2006).

[107] *Id.*

[108] Pub. L. No. 109-2, 119 Stat. 4 (2005) (codified in scattered sections of title 28 of the U.S. Code).

[109] The diversity requirement is satisfied if "any member of a class of plaintiffs is a citizen of a State different from any defendant." 28 U.S.C. § 1332(d)(2).

[110] *See, e.g.*, Jennifer J. Johnson, *Securities Class Actions in State Court*, U. CIN. L. REV. (forthcoming), *available at* http:/ssrn.com/abstract=1856695.

D. <u>Primary Liability for Secondary Actors under Rule 10b-5 after *Central Bank*</u>

Recent court cases have addressed the extent to which secondary actors' actions may make them primarily liable under Rule 10b-5. Prior to *Central Bank*, courts had not often distinguished between secondary actor conduct that was subject to primary liability and conduct that amounted only to aiding and abetting. After *Central Bank*, plaintiffs brought actions based on secondary actors' involvement in fraudulent transactions or participation in making fraudulent statements. The Supreme Court has recently decided two cases on the scope of liability for secondary actors under Rule 10b-5.

1. *Stoneridge* case addresses scheme liability and reliance

After *Central Bank*, instead of alleging that defendants made a fraudulent statement, plaintiffs in some rule 10b-5 cases alleged that the secondary actors were part of a "scheme to defraud." The concept of scheme liability is premised on subsections (a) and (c) of Rule 10b-5, which respectively make it unlawful to "employ any device, scheme, or artifice to defraud" and prohibit "any act, practice, or course of business which operates . . . as a fraud or deceit . . . in connection with the purchase or sale of any security."[111] Under this theory, active participation in a scheme to defraud would be sufficient to create liability in a Rule 10b-5 action for securities fraud. Appellate courts varied in their support of such a concept of scheme liability, with some circuits finding scheme liability sufficient for secondary actors to be liable in a 10b-5 action.[112]

In 2008, the Supreme Court addressed the issue of scheme liability in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[113] In that case, plaintiffs alleged that Charter Communications, Inc. (Charter), the company being sued for primary liability for securities fraud, entered into sham transactions with two vendors.[114] The vendors allegedly were aware of the fraudulent transactions, which Charter used to inflate its operating revenues and cash flow in financial statements presented to its investors.[115] Investors sued the two vendors, among others, alleging that they participated in a "scheme to defraud" with Charter and should therefore be held liable under 10b-5, regardless of the fact that they made no public statement of their own.[116]

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[111] 17 C.F.R. § 240.10b-5.

[112] *See, e.g.*, *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006).

[113] 552 U.S. 148 (2008).

[114] *Id.* at 153.

[115] *Id.* at 155.

[116] *Id.*

The Court held that it is not sufficient for the defendant to have merely participated in a scheme to defraud, but that the plaintiff actually must have relied on the defendant's participation or conduct for liability to attach. Because the vendors neither had a duty to Charter's investors nor made a statement on which the investors relied, the vendors were not liable. The Court reasoned that to allow scheme liability where no reliance exists would create a way for plaintiffs to bring suit for conduct that would otherwise be considered aiding and abetting, because the conduct did not meet the necessary elements for primary liability. And because Congress chose not to overturn *Central Bank* by creating a private aiding and abetting cause of action for securities fraud when enacting PSLRA, the Court concluded that there still was no private aiding and abetting action under Rule 10b-5.[117]

2. *Janus* case addresses scope of Rule 10b-5 prohibition of fraudulent statements

Most recently, in *Janus Capital Group, Inc. v. First Derivative Traders*,[118] the Supreme Court has addressed what must be shown to establish liability under Rule 10b-5(b), which prohibits "*mak[ing]* any untrue statement of a material fact" in connection with the purchase or sale of securities.[119] *Janus* involved an investment adviser that provided advice and administration services to a group of mutual funds that issued prospectuses containing false statements. In a 5-4 decision, the Court found that the investment adviser did not "make" the statement contained in the prospectuses because it did not have "ultimate authority over the statement, including its content and whether and how to communicate it."[120] The Court noted that without control, one who prepares a statement cannot "make" a statement in its own right. Although the Court recognized that there was a close relationship between the investment adviser and the mutual funds, it found that the investment adviser was not the maker of statements by its client mutual fund. The Court observed that "[a]ny reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the courts."[121]

The dissent disagreed with the majority's analysis of Rule 10b-5, concluding that certain secondary actors, such as management companies and individual company officers, might "make" statements contained in a firm's prospectus. The dissent pointed out that each of the fund's officers was an employee of the investment adviser and that those employees both carried out the fund's daily activities and implemented its long term strategies.[122] The dissent went on to

[117] *Id.* at 167. As noted below, however, the SEC successfully enforced against the vendors.

[118] 131 S. Ct. 2296 (2011).

[119] 17 C.F.R. § 240.10b-5(b) (emphasis added).

[120] 131 S. Ct. at 2302.

[121] *Id.* at 2304.

[122] *Id.* at 2306.

conclude that the specific close relationships alleged among the investment adviser, the fund and prospectus statements warranted the conclusion that the investment adviser "made" the statement.

PART IV. ADDITIONAL LEGAL AVENUES FOR PURSUING SECONDARY ACTORS AND COMPENSATING INVESTORS

Since the Supreme Court issued its *Central Bank* decision in 1994, there has been no aiding and abetting liability for secondary actors in private securities fraud cases litigated under Rule 10b-5. However, in certain circumstances, aiders and abettors of securities fraud may be subject to liability under other provisions of state or federal securities laws. The SEC and Department of Justice (DOJ) both have express statutory authority to impose sanctions on persons who aid and abet securities fraud. Other provisions of the federal securities laws also may give investors the right to bring suit against parties who have defrauded them, including secondary actors. Although SLUSA generally requires that class actions be brought in federal court, in certain circumstances, large institutional investors can bring non-class action suits (or small class action suits below the threshold triggering SLUSA) against aiders and abettors in state court where the heightened PSLRA standards do not apply. Finally, the SEC is authorized to distribute money penalties that it collects to injured investors under the Fair Funds provision of the Sarbanes-Oxley Act; this provides an alternative method of compensating investors.

A. Federal Government Enforcement

In PSLRA, Congress expressly authorized the SEC to pursue persons who knowingly provide substantial assistance to primary violators of the securities laws.[123] The Dodd-Frank Act amended the pleading standard in the 1934 Act from "knowingly" to "knowingly or recklessly." The lower pleading standard may enable the SEC to more easily bring cases for aiding and abetting securities fraud. The SEC can bring civil actions against secondary actors in administrative proceedings or court actions. The possible resolutions in these actions include, among other remedies, injunctions, disgorgement orders, civil penalties, and orders barring or suspending individuals from serving as officers or directors of securities issuers or participating in the securities industry.[124] Even if an investigation by the SEC does not result in an enforcement action, the SEC can publicize the results of its investigations.[125]

[123] Pub. L. No. 104-67, §929*O*, 109 Stat. 737 (1995).

[124] 15 U.S.C. § 78u (Investigations and Actions by SEC); 15 U.S.C. § 78u-1 (Civil Penalties for Insider Trading); 15 U.S.C. § 78u-2 (Civil Remedies in Administrative Proceedings); 15 U.S.C. § 78u-3 (Cease-and-Desist Proceedings); 15 U.S.C. § 78 (Penalties for Willful Violations); 15 U.S.C. §78u(d)(1) (Injunctions); 15 U.S.C. § 78u(d)(2) (Barring service as officer or director).

[125] 15 U.S.C. § 78u(a).

The SEC has used its authority to enforce the securities laws against aiders and abettors. Before the *Stoneridge* class action lawsuit was filed, the SEC had recovered around $45 million in disgorgement and civil penalties from the two secondary actors that the SEC found to have aided and abetted the violations by Charter Communications.[126] Similarly, the SEC has pursued secondary actors involved in other enforcement or civil actions.

DOJ has authority to impose criminal sanctions to enforce the federal securities laws, including aiding and abetting securities fraud.[127] The SEC may refer violations to DOJ to determine if criminal sanctions are appropriate, and the U.S. Attorney's Office decides independently when a violation warrants a criminal prosecution. Any person convicted of violating the 1934 Act is subject to a maximum fine of $5 million ($25 million for corporations) and a maximum of 20 years imprisonment. In many instances, DOJ has conducted investigations and brought criminal prosecutions in the same cases pursued by the SEC. In 2010 there were 12 U.S. federal securities class action law suits that had DOJ involvement. Additionally, DOJ pursued secondary actors that aided and abetted fraud in the Enron and AOL Time Warner cases. Furthermore, it obtained fines against individual officers of Charter Communications, who were accused of conspiracy and aiding and abetting the alleged fraud at issue in *Stoneridge*.[128]

The Sarbanes-Oxley Act gives the SEC authority to distribute civil money penalties for federal securities law violations to investors who have been harmed by those violations.[129] Prior to enactment of Sarbanes-Oxley, the SEC could seek disgorgement of defendants' profits both in federal court and in administrative proceedings, and disgorged funds could be distributed to investors. The SEC describes disgorgement as forcing defendants "to give up the amount by which they were unjustly enriched."[130] Sarbanes-Oxley provides the SEC with authority to combine any civil penalty with the disgorgement amount in a Fair Fund to compensate victims of the violation. In a recent report, we recently found that from 2002 through February 2010, $9.5 billion in disgorgements had been ordered, of which $9.1 billion had been collected and

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[126] *See* SEC v. Scientific-Atlanta, Inc., SEC Litig. Release No. 19,735 (June 22, 2006); In re Motorola, Inc., Exchange Act Release No. 55,737 (May 8, 2007).

[127] The principal tool for criminal enforcement of the securities laws is 18 U.S.C. § 2(a), which states that "[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures the commission, is punishable as a principal." Offenses include violations of the criminal provisions of the securities laws. 15 U.S.C. § 78ff(a).

[128] *See* Judgment, *United States v. Barford*, No. 4:03CR00434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. Smith*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. Kalkwarf*, No. 4:03CR434 (E.D. Mo. Apr. 22, 2005); Judgment, *United States v. McCall*, No. 4:03CR00434 (E.D. Mo. Apr. 22, 2005).

[129] Pub. L. No. 107-204, 116 Stat. 745 (2002); 15 U.S.C. § 7246.

[130] SEC, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES-OXLEY ACT OF 2002 at 3 (2003).

$6.9 billion had been distributed to investors.[131] We also found that the SEC was taking steps to better capture, report, and manage the programmatic and financial impact of the collections and distribution process, but it was too early for us to determine the impact and ultimate success of the SEC's efforts at improving the program. Before the enactment of the Dodd-Frank Act, penalties were only distributed to investors if there were a disgorgement order against the defendant. The Dodd-Frank Act enables the SEC to distribute penalties in cases where there is no disgorgement, providing the SEC with greater flexibility to compensate injured investors.[132]

B. Other Private Causes of Action

In some circumstances, secondary actors can be subject to liability under other provisions of the federal securities laws. Both the 1933 Act and the 1934 Act provide investors with a right to bring a private suit against market participants who have defrauded them. The 1933 Act provides private rights of action to investors injured by violations of the registration and disclosure requirements in the following circumstances:

- Section 11 of the 1933 Act provides an express private right of action for damages for material misrepresentations or omissions in a registration statement for an offering of new securities. Section 11 applies to issuers, signatories, directors of the issuer, and underwriters. Section 11 also provides for the liability of an expert, including accountants, engineers, and appraisers, or any person who consents to be named as having prepared or certified any portion of the registration statement.[133] In general, "materiality" refers to those facts that a reasonable investor would consider significant in making an investment decision.[134] Defendants in a section 11 claim can avoid liability by showing that they conducted a reasonable investigation with regard to the registration statement.[135] However, this defense does not apply to issuers.

- Section 12 of the 1933 Act provides remedies to investors who purchase securities that were sold in violation of the Act's registration requirements or by means of a false or misleading communication. Section 12(a)(1) provides that anyone who offers or sells a security in violation of the registration requirements is liable in a civil action to the person purchasing the security.[136] Damages are limited to the return of

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[131] GAO, SECURITIES AND EXCHANGE COMMISSION: INFORMATION ON FAIR FUND COLLECTIONS AND DISTRIBUTIONS, GAO-10-448R (2010).

[132] 15 U.S.C. § 7246(a).

[133] *Id.* § 77k(a)(4).

[134] 17 C.F.R. § 230.405..

[135] 15 U.S.C. § 77k(b)(3)(B).

[136] *Id.* § 77*l*(a)(1).

the purchase price of the security with interest upon return of the security.[137] Section 12(a)(2) creates an express private remedy for material oral and written misstatements or omissions in connection with the sale or offer of a security.[138] Under section 12(a)(2), the seller or offerer of the security is liable to the purchaser of the security. Like section 11, section 12(a)(2) provides for a "due diligence" defense that permits a defendant who exercised reasonable care but did not know of the untruth or omission.

The 1934 Act also provides private remedies for fraud and manipulation, including remedies for violations of a prohibition on manipulative practices,[139] and a private right of action for investors who have been injured due to reliance on a material misstatement or omission of fact in connection with a document required to be filed with the SEC under the 1934 Act.[140]

C. Controlling Person Liability

The 1933 and the 1934 Acts impose liability not only on the person who actually commits a securities law violation, but also on the entity or individual who controls the violator. Section 20(a) of the 1934 Act provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person."[141] However, no liability exists if "the controlling person acted in good faith and did not directly or indirectly induce the acts constituting the violation or cause of action."[142] Section 15 of the 1933 Act imposes similar liability, but is limited to violations of sections 11 or 12 of the Act.[143] Although the provisions are not identical, they have been interpreted and applied similarly.[144]

Although section 20(a) does not define the term "control," the SEC has promulgated a rule defining "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or

[137] *Id.* § 77*l* (a).

[138] The Supreme Court has held that section 12(a)(2) applies only to public offerings. *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995).

[139] 15 U.S.C. § 78i.

[140] *Id.* § 78r(a).

[141] *Id.* § 78t(a).

[142] *Id.*

[143] *Id.* § 77*o*.

[144] The two standards may differ concerning whether knowledge of the misstatements is required. HAZEN, *supra* note 28, § 7.12, at 344.

otherwise."[145] However, the determination of whether control exists depends on the particular factual circumstances of each case.

Section 929P(c) of the Dodd-Frank Act clarified that the SEC can maintain an enforcement action for control person liability under section 20(a); this provision resolved a conflict among the U.S. Courts of Appeals over this issue.[146]

D. State Law Liability

In addition to the various remedies available against secondary actors under federal law, many states' "blue sky laws" impose express private liability for secondary actors.[147] Many state statutes extend liability not only to control persons but also to other actors who participate or materially aid in the fraudulent securities transaction.[148] The conduct required for secondary liability varies from state to state, as states' definitions of "participate" and "materially aid" differ, but many states have some type of private cause of action for aiding and abetting securities fraud. However, since enactment of SLUSA, state secondary liability causes of action generally may only be brought by individuals or classes of 50 plaintiffs or fewer.[149] Plaintiffs that are members of large class actions are therefore generally unable to utilize state blue sky laws to hold secondary actors liable for aiding and abetting securities fraud.

PART V. CURRENT STANDARDS FOR SECONDARY LIABILITY IN LIGHT OF RECENT DEVELOPMENTS

As discussed above, while secondary actors are not liable to private plaintiffs for aiding and abetting securities fraud, they may be liable for primary violations of Rule 10b-5. This scope of this liability has been shaped by the Supreme Court's decisions in *Central Bank*, *Stoneridge*, and *Janus*, as well as by PSLRA's procedural and substantive revisions applicable to securities fraud lawsuits. Additionally, secondary actors are subject to liability under other provisions of 1933 and 1934 Acts, including those that prohibit

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[145] 17 C.F.R. § 230.405.

[146] 15 U.S.C. § 78t(a).

[147] *Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the Subcomm. on Securities, S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. 47 (1997) (prepared statement of Arthur Levitt, Jr., Chairman & Isaac C. Hunt, Jr., Commissioner, U.S. Securities and Exchange Commission) (stating that according to the SEC, 49 of 50 states authorize private rights of action for aiding and abetting violations of state securities laws).

[148] Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, DEL. J. CORP. L. (forthcoming) (citing UNIF. SEC. ACT § 410(b) (1956) (amended 1958); UNIF. SEC. ACT § 509(b) (2002)), *available at* http://ssrn.com/abstract=1803762.

[149] 15 U.S.C. § 78bb(f)(5)(B)(ii).

misrepresentations in registration statements filed for publicly traded securities or in connection with manipulative practices.

A. Liability of Attorneys

Liability of attorneys to investors has been based on the attorneys' formal legal opinions as well as their direct contacts with investors. For example, when an attorney makes a materially false or misleading statement as part of an opinion intended to be used by a third-party investor, the attorney may be held primarily liable under Rule 10b-5. Additionally, attorneys will be treated as professionals for purposes of section 11 of the 1933 Act when providing expert opinions.[150] Attorneys who write tax opinions have a duty to make inquiry into all relevant facts, to be satisfied that the material facts are accurately and completely described in the offering materials, and to assure that any representations about future activities are clearly identified, reasonable, and complete.[151] One federal appeals court has ruled that a knowingly or recklessly false tax opinion letter, which the attorneys expressly consented could be distributed to investors, could give rise to primary liability under Rule 10b-5.[152] Another federal appeals court has ruled that recklessly false tax opinion letters could be the basis for primary Rule 10b-5 liability. Although the opinion letters contained disclaimers (that they were based only on facts provided by the client), the court held that the attorney might nonetheless be liable where the law firm knew or had reason to know that the factual description of the transaction provided by the client was materially inaccurate.[153] In a recent case, *AFFCO Investments 2001 L.L.C. v. Proskauer Rose, L.L.P.*, the defendant law firm worked behind the scenes to prepare model opinions supporting the validity of a tax shelter.[154] The plaintiffs participated in the tax shelter based, in part, on the promises of opinions from unnamed law firms. After their investment, the plaintiffs received the favorable tax opinions from the defendant. Citing *Stoneridge*, the Fifth Circuit Court of Appeals ruled that without direct attribution to the law firm of its role in the tax scheme, reliance on its participation could not be shown.[155]

In contrast, when a client makes a misrepresentation to investors, courts have held that the attorneys drafting the documents for the client cannot be held liable for the misrepresentations. In *Schatz v. Rosenberg*, the attorney preparing closing documents for the client's sale of a control block of stock

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[150] *In re Am. Cont'l Corp./Lincoln Sav. & Loan Sec. Litig.*, 794 F.Supp. 1424, 1453 (D. Ariz. 1992).

[151] ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 346 (1982) (discussing tax law opinions in tax shelter investment offerings). Formal Opinions supplement the Model Rules and Code by providing guidelines in certain areas.

[152] *Ackerman v. Schwartz*, 947 F.2d 841, 848-49 (7th Cir. 1991).

[153] *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480, 485-86 (3d Cir. 1994).

[154] 625 F.3d 185 (5th Cir. 2010).

[155] *Id.* at 192-195.

could not be held liable under Rule 10b-5 although the attorney knew that representations in the documents that were relied on by purchasers were false.[156] The federal appeals court in that case found that the attorney could not be held liable for failing to disclose information about a client to a third party, absent some fiduciary or confidential relationship to the third party.[157] Another federal appeals court held that in cases in which a law firm assists in drafting materially false offering documents, but itself does not make any false statement, the firm cannot be held primarily liable under Rule 10b-5 for the false statements made by its clients.[158] The court also determined that the law firm was not primarily liable for any material omissions, because Rule 10b-5 proscribes failure to state material facts only when the defendant has a duty to disclose. The court found that the law firm did not have such a duty. In another federal appeals case, the *PIMCO* case, attorneys allegedly reviewed and revised portions of an issuer's offering documents that they knew contained false statements.[159] The Second Circuit held in *PIMCO* that secondary actors can be held liable in a private Rule 10b-5 action only for those statements attributable to them.[160] In the recent *Janus* case, the Supreme Court determined that attribution is normally required for liability.[161]

However, when an attorney makes representations directly to prospective purchasers of securities, the attorney is under an obligation to tell the truth about those securities and may be held liable under Rule 10b-5 if those representations are materially misleading. In *Rubin v. Schottenstein, Zox & Dunn*, the Sixth Circuit found that when an attorney elects to speak with prospective investors, "he assumes a duty to provide complete and non-misleading information with respect to the subjects on which he undertakes to speak" and "he assumed a duty to speak fully and truthfully on those subjects."[162]

B. Liability of Investment Banks

Investment banks may be primarily liable in private Rule 10b-5 actions for fraud in connection with the purchase or sale of securities if all the requirements for liability are met. In litigation involving the now-insolvent Enron Corporation, investors sued investment banks and law firms that were alleged to have helped Enron report financial results fraudulently.[163] The

[156] 943 F.2d 485, 492-93 (4th Cir. 1991).

[157] *Id.*

[158] *Ziemba v. Cascade Int'l, Inc.* 256 F. 3d 1194, 1205-07 (11th Cir. 2001).

[159] *Pacific Inv. Mgmt. Co. v. Mayer Brown LLP*, 603 F.3d 144, 149-50 (2d Cir. 2010).

[160] *Id.* at 157-58.

[161] 131 S. Ct. 2296 (2011).

[162] 143 F.3d 263, 268 (6th Cir. 1998). *See also Thompson v. Paul*, 547 F.3d 1055, 1062 (9th Cir. 2008).

[163] Donald C. Langevoort, *Reading Stoneridge Carefully: A Duty-Based Approach to Reliance and Third-Party Liability Under Rule 10b-5*, 158 U. PA. L. REV. 2125 (2010).

defendants were alleged to have engaged in a series of transactions with Enron that enabled it to temporarily take liabilities off its books and to book revenue from transactions. Although the Federal District Court for the Southern District of Texas denied the defendants' motion to dismiss and allowed the case to proceed,[164] the Fifth Circuit reversed[165] and found that the investors failed to state a claim for primary violations against the lender. The Fifth Circuit found that because the bank's conduct was not conduct on which an efficient market could be presumed to rely, the fraud-on-the-market presumption did not apply. The court also ruled that the lack of any duty running from the banks to investors prevented the investors from relying on the *Affiliated Ute* presumption of reliance to allow the class action to go forward. The Supreme Court declined to review this appellate decision.[166] Other scheme liability cases involved investment banks that provided services to the company. The district court in *In Re Parmalat Sec. Litigation* cited *Stoneridge* in determining that investors could not have relied on the deceptive disclosures made by the defendant.[167] As discussed below, investment banks are often named as defendants in litigation against securities analysts affiliated with the bank.

Investment banks also serve as underwriters in connection with the issuance of securities. Section 2(a) of the 1933 Act defines an underwriter as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation under such undertaking."[168] Underwriters may be held liable under sections 11 and 12(a)(2) of the 1933 Act. Section 11 imposes liability on underwriters "in case any part of the registration statement, when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[169] Section 12(a)(2) imposes liability on "any person who offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements . . . not misleading."

Under both sections 11 and 12, an underwriter may absolve itself of liability by establishing an affirmative "due diligence" defense. This defense may be invoked if the underwriter proves it undertook a "reasonable investigation" to

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[164] *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 529 F. Supp. 2d 644 (S.D. Tex. 2006).

[165] *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007).

[166] *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA) Inc.*, 482 F.3d 372 (5th Cir. 2007), *cert. denied*, *Regents of the Univ. of Cal. v. Merrill Lynch, Pierce Fenner & Smith, Inc*, 552 U.S. 1170 (2008).

[167] *In re Parmalat Secs Litig.*, 570 F. Supp. 2d 521, 524 (S.D.N.Y. 2008).

[168] 15 U.S.C. § 77b(a)(11).

[169] *Id.* § 77k(a)(5).

determine that the statements in the registration statement were true or exercised "reasonable care" in determining whether statements in registration statement were true.[170] An underwriter is not liable for any part of the registration statement that is made "on the authority of an expert" if the underwriter shows that it "had not reasonable ground to believe and did not believe" that there were material misstatements or omissions in that part of the registration statement.[171]

A recent First Circuit decision, *SEC v. Tambone*, held that an underwriter who has a duty to investigate the nature and circumstances of an offering does not make an implied representation to investors that statements in the prospectus are truthful for purposes of primary Rule 10b-5 liability.[172] In *Tambone*, the prospectus was alleged to contain statements that the underwriter knew to be false.

C. Liability of Accountants

Independent public accountants can be subject to primary liability if their audit reports, which are included in public reports of the public company, or other public statements (or omissions) otherwise meet the elements of primary liability.[173] According to AICPA officials with whom we spoke, a significant percentage of private civil actions naming public company auditors are for allegations of liability under Rule 10b-5 for false or misleading statements reflected in auditor reports. One important aspect of Rule 10b-5 cases against public accountants is the requirement to plead and prove that the independent auditor acted with scienter. Many courts have held that alleged violations of applicable auditing and accounting standards by the external auditor are not sufficient, by themselves, to establish scienter. For example, courts have held that negligent performance of an audit, including failure to design an audit that would have resulted in reviewing a fraudulent transaction or failure to review certain transactions to such a degree that company manipulation of the transaction would have been detected, does not

[170] The SEC has promulgated Rule 176 to identify certain circumstances bearing on the reasonableness of the investigation and the determination of what constitutes reasonable ground for belief. 17 C.F.R. § 230.176.

[171] 15 U.S.C. § 77k(b)(3)(C).

[172] *SEC v. Tambone*, 597 F.3d 436, 447-448 (1st Cir. 2010).

[173] *See McGann v. Ernst & Young*, 102 F.3d 390 (9th Cir. 1996), and cases cited therein. *Compare with Wright v. Ernst & Young*, 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999) (auditor's alleged review and tacit approval of company press release does not result in primary liability where auditor did not make a public statement about it). *See Central Bank*, 511 U.S. at 191 ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.") (emphasis in original).

meet the requirement to prove intent to defraud or recklessness.[174] Also, as discussed above, section 11 of the 1933 Act expressly subjects external auditors to civil liability for false or misleading statements they make in connection with their audits of public company registration statements. To the extent that external auditors do not engage in conduct that subjects them to primary liability—in other words, issuing audit opinions or other statements to investors—they are not subject to a private cause of action for secondary liability under the federal securities laws. However, accountants also are subject to the tort or statutory civil liability laws of the state, District of Columbia, or U.S. territory in which the conduct giving rise to liability may have occurred. The sources and standards for liability to investors and others under these laws vary by jurisdiction.

D. Liability of Credit Rating Agencies

Several amendments enacted as part of the Dodd-Frank Act increase the potential liability of credit rating agencies in securities fraud actions. First, prior to the enactment of the Dodd-Frank Act, SEC Rule 436(g) provided that a security rating assigned to a class of debt securities or a class of preferred stock by an NRSRO is not a part of the registration statement prepared by an expert under section 11 of the 1933 Act. The Dodd-Frank Act supersedes the regulation so that NRSROs may be exposed to liability as experts under section 11 of the 1933 Act for material misstatements and omissions with respect to the ratings.[175] Second, the Dodd-Frank Act also specifically provides that the enforcement and penalty provisions of the 1934 Act "apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws."[176] Third, the law modifies the requisite "state of mind" for private securities fraud actions for money damages against a credit rating agency. An investor or other plaintiff may now satisfy pleading standards by stating facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the rated security or the credit rating agency failed to obtain reasonable verification of such factual elements from a competent party independent of the issuer.[177] Fourth, the Dodd-Frank Act clarifies that ratings are not forward-looking statements for purposes of the PSLRA safe harbor.[178] Fifth, the Dodd-Frank Act also increases the SEC's enforcement authority in connection with NRSROs.[179] Finally, the Dodd-Frank

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[174] *See, e.g.*, *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9th Cir. 1994), *cert. denied*, 516 U.S. 868 (1995); *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615 (9th Cir. 1994).

[175] 15 U.S.C. § 78m note.

[176] *Id.* § 78o-7(m)(1).

[177] *Id.* § 78u-4(b)(2).

[178] *Id.* § 78o-7(m)(1).

[179] *Id.* §§ 78o-7(d)(1), 78o-7(d)(2).

Act requires every federal agency to review existing regulations that require the use of an assessment of the credit-worthiness of a security or money-market instrument and modify the regulations to remove any reference or the requirement of reliance on credit ratings and substitute with an appropriate standard of credit-worthiness.[180]

Some federal courts have determined that rating agencies have First Amendment protection and are liable only for "actual malice" in making their ratings.[181] Under this standard, the rating agencies would be liable only if they knew their statements were false or the statements were made with reckless disregard of the truth. In *Compuware Corporation v. Moody's Investors Services*,[182] the Sixth Circuit determined that in a breach of contract claim, the actual malice standard applied to credit ratings published by Moody's. In *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.* the Federal District Court for the Southern District of New York determined that First Amendment protections may not apply when ratings information is made available only to a small group of investors rather than to the general public.[183] The court determined that because the ratings were distributed to a small number of investors, they were not "matters of public concern" and thus may not be protected by the First Amendment.

E. Liability of Securities Analysts

Securities analysts may be subject to primary liability if publication of their research reports meets the test for primary liability. Investors have brought lawsuits against securities analysts and investment banks alleging that securities analyst reports were false and misleading and intended to artificially inflate the value of securities. As indicated above, sell-side analysts may be affiliated with or employed by investment banks or other financial firms that have clients for whom they provide services. These clients may be the same companies that securities analysts are researching and about which they write reports. The analyst may face a conflict of interest if the investment bank client will be benefited by positive coverage in his research report. FINRA and the New York Stock Exchange (NYSE) have promulgated rules on analyst recommendations, including increased supervision and restrictions on activities designed to prevent potential conflicts of interests.[184] The FINRA

[180] 15 U.S.C. § 78o-7 note.

[181] This standard originated in *NewYork Times v. Sullivan*, 376 U.S. 254, 279-80 (1964), where the Supreme Court held that the First Amendment protects a public official for a defamatory falsehood relating to his official conduct unless he proves the statement is made with knowledge that it is false or with reckless disregard of the whether it was false.

[182] 499 F.3d 520, 530 (6th Cir. 2007).

[183] 651 F. Supp. 2d 155, 175-176 (S.D.N.Y. 2009).

[184] FINRA Rule 2711; NYSE Rule 472. In addition, SEC Regulation AC requires that a research report disseminated by a broker or dealer include certifications by the research analyst that the views expressed in the report accurately reflect the analyst's personal views. 17 C.F.R. § 242.500.

and NYSE rules are designed to help insure analyst independence. The First Circuit has found that even though a securities analyst may have a conflict of interest, the plaintiff in a securities fraud case must show that particular statements in the recommendation were false and misleading when made in order to establish liability.[185]

Courts have also focused on loss causation and reliance in Rule 10b-5 cases involving securities analysts and investment banks. In a case where investors in companies that Merrill Lynch's research analysts covered alleged that the opinions were materially misleading and violated section 10(b), the Second Circuit determined that the plaintiffs did not sufficiently plead that the alleged misrepresentations and omissions caused the claimed losses.[186] In *Fogarazzo v. Lehman Brothers, Inc.* the plaintiffs alleged that Lehman Brothers, Morgan Stanley and Goldman Sachs issued fraudulently optimistic research reports that artificially inflated the stock price of a company. The Federal District Court for the Southern District of New York determined that for class certification purposes, the plaintiffs had adequately pled loss causation by showing that the element of loss causation may be proven class-wide., which can be shown by proposing a suitable methodology.[187] In addition, some courts have determined that the fraud-on-the-market presumption of reliance can apply to lawsuits against securities analysts without a specific finding that the analysts' misrepresentations actually affected the price of the securities traded in the open market.[188] Commentators have differed over whether a lawsuit against a securities analyst under section 10(b) is likely to be successful.[189]

PART VI. PROPOSALS AND POTENTIAL IMPLICATIONS OF CREATING A PRIVATE CAUSE OF ACTION FOR AIDING AND ABETTING SECURITIES FRAUD

Legislation recently has been introduced in the U.S. Senate and House of Representatives, in 2009 and 2010, respectively, to create a private right of

[185] *See In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 53-54 (1st Cir. 2005) ("[T]he fact that an organization is ethically challenged does not impugn every action that it takes. In a securities fraud case, the plaintiffs still must carry the burden, imposed by the PSLRA, of pleading facts sufficient to show that the particular statements sued upon were false and misleading when made.").

[186] *Lentell v. Merrill Lynch & Co., Inc*, 396 F.3d 161, 172-174 *cert. denied*, 126 S. Ct. 421. The plaintiffs did not allege facts that would establish that the analyst's misstatements and omissions concealed the risk that materialized and played some part in diminishing the market value of the securities.

[187] 263 F.R.D. 90, 106-107 (S.D.N.Y. 2009).

[188] *See In re Salomon Analyst Metromedia Litig.*, 544 F. 3d 474, 480-483 (2d Cir. 2008); *In re Healthsouth Securites Litigation*, 257 F.R.D. 260 (N.D. Alabama 2009)

[189] *See* John C. Coffee, Jr., *Security Analyst Litigation*, N.Y. L.J. at 5 (2001); Elizabeth A. Nowicki, *A Response to Professor Coffee: Analyst Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 U. CIN. L. REV. 1305 (2004).

action to permit investors to pursue claims against secondary actors for aiding and abetting securities fraud.[190] Both bills proposed to amend section 20(e) of the 1934 Act[191] to include an express private right of action for aiding and abetting a violation of the securities laws. The bills would make individuals and firms that knowingly or recklessly provide substantial assistance to primary actors in a securities fraud liable to investors.

Proponents and opponents have made various policy arguments to support or oppose creating a private right of action for aiding and abetting securities fraud. Because enacting a private cause of action for aiding and abetting could expand the volume of securities class action lawsuits, many of these arguments reflect policy concerns that have been expressed about class action securities litigation generally. These concerns include whether these lawsuits effectively and efficiently deter securities fraud, whether they appropriately compensate injured investors and how they impact the capital markets and the economy.

Proponents of creating such an action have included attorneys that represent investors; public retirement funds, including the California State Teachers' Retirement System, New York State Common Retirement Fund, and Pennsylvania State Employees' Retirement System; the North American Securities Administrators Association; investor and consumer advocacy groups, including AARP, the National Association of Shareholder and Consumer Attorneys, and the Consumer Federation of America; former SEC commissioners; and law professors.[192] Opponents of creating such an action have included industry and business associations, such as the American Institute of Certified Public Accountants, U.S. Chamber of Commerce, Business Roundtable, and Securities Industry and Financial Markets Association; securities firms; U.S. securities exchanges, including the New York Stock Exchange and Nasdaq; former SEC commissioners; and law professors. A summary of key policy arguments made for and against creating a private right of action for aiding and abetting securities fraud and expanding liability in connection with securities fraud class actions is set forth below.

A. Deterring Fraud

Deterrence is often cited as a primary goal of enforcement of securities laws. A number of parties are involved in the enforcement of Rule 10b-5, including the SEC, the Department of Justice, private investors in class action litigation, and state officials that bring enforcement actions. Proponents of creating a private right of action for aiding and abetting securities fraud argue that such action is a necessary supplement to SEC enforcement and provides an

[190] *See* H.R. 5042, 111th Cong. (2010); S. 1551, 111th Cong. (2009).

[191] 15 U.S.C. § 78t.

[192] Some of these entities have not expressly supported creating a private right of action for aiding and abetting.

additional deterrent to fraud. SEC enforcement actions serve as one of the primary tools for deterring fraud by secondary actors. In light of the financial scandals that have occurred over the past decade that were aided by secondary actors, proponents question whether SEC alone can adequately deter securities fraud. They note that the SEC and Congress repeatedly have recognized that SEC enforcement is not sufficient to deter wrongdoers and compensate investors. In that regard, proponents contend that private aiding and abetting liability would serve a critical deterrent function. They also note that private enforcement is not subject to government budgeting constraints and is entrepreneurially motivated, enabling private plaintiffs and their attorneys to vigorously pursue secondary participants. Moreover, they argue that the prospect of a large recovery and, hence, large attorney's fees are necessary to attract the attention of the creative entrepreneurial attorney.

Proponents also argue that allowing injured investors to seek recourse from secondary actors that may serve as "gatekeepers" would not only better deter them from aiding and abetting fraud but also better motivate them to be diligent gatekeepers. Gatekeepers have been cited as including accountants, securities analysts, credit rating agencies, and underwriters.[193] These secondary actors assist publicly held companies with their securities transactions and related disclosures—for example, by verifying or certifying the accuracy of financial and other information. In some cases, publicly traded companies cannot complete their securities transactions without the approval of such secondary actors. As a result, these secondary actors can provide a check on securities fraud to the benefit of investors. Proponents contend that the current legal regime that excludes aiding and abetting liability improperly shields secondary actors from private liability and, thus, does not sufficiently deter them from aiding and abetting fraud or encourage them to be more diligent gatekeepers. According to proponents, deterring secondary actors that serve as gatekeepers from engaging in fraud can be easier than deterring the primary violators, because they do not stand to reap the same gain as the primary violators. One commentator has also advocated a modified strict liability regime for gatekeepers.[194]

Opponents respond that a private right of action for aiding and abetting is unnecessary for deterrence of securities fraud, because public enforcement under the current regulatory structure is adequate. First, the SEC employs a broad range of statutory and administrative tools to combat fraud involving aiders and abettors and that authority has been expanded by the Dodd-Frank Act.[195] According to opponents, the SEC has used this authority vigorously, in

[193] *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004).

[194] Frank Partnoy, *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491 (2001).

[195] Dodd-Frank lowered the scienter standard that the SEC must show to prove aiding and abetting violations from knowledge to recklessness and made civil penalties available in enforcement actions.

large part to pursue individual wrongdoers. They note that SEC enforcement actions, more so than private lawsuits, have a significant stigma that can cause reputational damage. Second, DOJ has broad statutory powers to pursue secondary actors who assist others in committing securities fraud.[196] Opponents note that the threat of a criminal indictment is a serious deterrent, because even an indictment, and certainly a conviction, could amount to a professional death sentence. They further note that the SEC and DOJ have the expert judgment to decide when to prosecute alleged aiders and abettors of securities fraud, and these agencies, unlike private attorneys, do not have a profit motive that can bias their decisions.

Third, opponents cite the authority of the PCAOB to promulgate auditing standards and bring enforcement actions against accounting firms and individual auditors. Finally, opponents note that laws in several states provide penalties that potentially help to deter secondary actors from aiding and abetting securities fraud. These include state “blue sky” laws that permit attorneys general and state regulators to seek fines and obtain restitution from,[197] and impose criminal sanctions against,[198] anyone who aids and abets state securities law violations.

Opponents also question the ability of private securities class actions to deter fraud, citing research showing that resolution of class actions does not depend on the merits of the case, but are based on the settlement value to the defendant and the fact that defendants view settlement as a cost of doing business. They also cite the fact that companies and insurers, not individual wrongdoers, pay settlements. Thus, the cost of settlements is ultimately borne by the corporation’s shareholders, not those that committed the fraud. Opponents of creating a private right of action for aiding and abetting securities fraud argue that such a right would lead to an increase in non-meritorious lawsuits and, in turn, an increase in litigation risk. Opponents note that creating the right of action would expand the range of parties and transactions that could give rise to a private lawsuit to include ordinary commercial transactions and customers, vendors, and others with no direct connection to the securities markets

Although PSLRA heightened the pleading requirements applicable to securities fraud claims, opponents note that getting non-meritorious complaints dismissed is still costly and difficult. Opponents maintain that a lawsuit under an aiding and abetting theory of liability would often be inherently fact

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[196] The U.S. Code criminalizes aiding and abetting violations of the securities laws and mail and wire fraud and conspiracy to violate those laws. 18 U.S.C. §§ 2, 371.

[197] *See, e.g.*, DEL. CODE ANN. tit. 6, § 7325; CAL. CORP. CODE §§ 25403(b), 25530-25536; *State v. McLeod*, 12 Misc. 3d 1157(A), 2006 WL 1374014, at *11 (N.Y.S.. 2006) (citing N.Y. GEN. BUS. LAW Art. 23-A §§ 352(1), 352-c(2) (the Martin Act)).

[198] *See, e.g.*, DEL. CODE ANN. tit. 6, § 7325; CAL. CORP. CODE §§ 25540-25542; 815 ILL. COMP. STAT. § 5/14.

intensive. Thus, according to opponents, there would be factual disputes in nearly every case, making it difficult for innocent parties to succeed on a motion to dismiss. Once a claim survives a motion to dismiss, the case is almost always settled regardless of the merits of the case. According to opponents, even if a case lacks merit, defendants may seek to settle for cost-benefit reasons, such as avoiding the high costs of discovery and litigation or the risks of massive damages. That is, the settlement value to defendants can turn more on the expected costs of their defense and less on the merits of the claim. Opponents maintain that going to trial is a risk that secondary actors are often unwilling to take, no matter how non-meritorious the case. This is in part because of the potential for these actors to be found jointly and severally liable if they knowingly participate in the fraud, putting them at risk of paying damages out of proportion to their involvement in the fraud.[199]

B. Compensating Investors

Proponents of creating a private right of action for aiding and abetting argue that such action would help to compensate investors who have been harmed through securities fraud. Proponents disagree with the criticism that class action lawsuits do not effectively compensate investors because current shareholders who do not benefit from the increase in stock price effectively compensate those who bought at fraud-related prices during the class period.[200] They note that this criticism does not apply to litigation against secondary actors because recoveries from secondary actors do not come from the corporation. They note that publicly traded companies that have committed securities fraud have become distressed or insolvent in some cases, leaving secondary actors who assisted issuers in the fraud as the only sources from which injured investors can recover their losses. According to proponents, such an outcome is more common for new companies but also has included other companies. Proponents also note that the argument that higher costs discourage firms from listing on U.S. securities exchanges does not apply directly where secondary liability is involved.

Proponents further note that in contrast to securities fraud cases that result in recoveries from issuers, recoveries from secondary actors provide unique compensation to investors, because the current shareholders of the issuers do not bear the cost of the recoveries. According to proponents, if investors were allowed to bring lawsuits against only issuers (and their directors and officers), they would not be able to recover much of their losses and, as a result, public confidence in the markets would suffer. Proponents maintain that private securities class actions currently represent the principal means by

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[199] As noted above, under the PSLRA, joint and several liability applies only when the conduct of the defendant is knowing. 15 U.S.C. § 78u-4(f).

[200] *See*, *e.g.*, Jill E. Fisch, *The Continuing Evolution of Securities Class Actions Symposium: Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333 (2009).

which financial penalties are imposed in cases of securities fraud and manipulation. Specifically, proponents contend that the SEC's disgorgement and civil money penalty authorities, although enhanced by Sarbanes-Oxley, are limited and generally can be used to recover only a fraction of the losses suffered by investors in large-scale securities frauds. As an example, they note that the SEC recovered $440 million from aiders and abettors in the Enron fraud, while investors recovered $7.3 billion in private suits.[201] They further argue that the SEC, with its limited resources, cannot bring actions in every one or even most of the securities fraud cases that have proliferated in recent years.

Opponents to creating private aiding and abetting liability argue that such action would not effectively or efficiently serve the goal of compensating injured investors. First, they note that damages resulting from securities fraud lawsuits historically have provided limited compensation to investors: such lawsuits, on average, have settled for a small percentage of losses alleged by investors, with a large proportion of total settlement value going toward attorney fees.[202] Second, opponents maintain that aiding and abetting liability would not increase the amount of money to which injured investors would be entitled; rather, it would increase only the number of actors who would be responsible for paying the judgment. Thus, according to opponents, investors would benefit only if the primary actor becomes insolvent or otherwise unable to pay a judgment.

Opponents note that when a securities fraud case involving securities traded in the secondary market is settled, a company's present shareholders, in effect, largely pay the company's past shareholders. According to opponents, investors with a diversified stock portfolio generally will receive settlement payments in some cases and make settlement payments in other cases but will be worse off in the end because of legal fees.[203] They argue that this circularity of payments renders class actions an illogical method of compensation. Moreover, according to opponents, the cost of settling and defending securities class action is passed to shareholders through higher directors and officers' insurance premiums. Finally, opponents contend that a private right of action for aiding and abetting is unnecessary for compensation purposes because of the government's ability to compensate injured investors without

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[201] The class action claim was based on a scheme theory of liability that was subsequently overturned, and other secondary actors who had not settled escaped liability when the class action was decertified. Opponents also note that damages were estimated at $40 billion.

[202] For the federal securities class action cases that settled during 1996–2010, NERA Economic Consulting found that attorneys' fees declined as a percentage of settlement value as the settlement values rose. For settlements less than $100 million, the median attorneys' fees as a percent of settlement value ranged from around 28 percent to 33 percent. For settlements between $100 and $500 million, the median attorneys' fees fell to around 23 percent. For settlements above $500 million, the median declined to around 9 percent.

[203] *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534 (2006).

the legal costs associated with private litigation. For example, they note that Sarbanes-Oxley directed the SEC to create a Fair Fund program to collect and return money that it recovers through disgorgement and civil penalties to injured investors. Similarly, DOJ is able to return ill-gotten gains directly to injured investors through restitution and forfeiture.

C. Effect on Investors and the Economy

Proponents of creating a private right of action for aiding and abetting securities fraud argue that such an action would not result in a significant increase in non-meritorious lawsuits. They note that PSLRA's reforms provide secondary actors with safeguards from non-meritorious lawsuits.[204] The heightened pleading standard is seen as a key safeguard as it is designed to make it more difficult for plaintiffs to allege securities fraud without specific evidence of misconduct. Even if a private aiding and abetting cause of action were created, proponents argue that PSLRA's pleading standard would enable defendants to succeed on a motion to dismiss when one is warranted. Proponents note that the pre-trial dismissal rate for securities class actions has nearly doubled since PSLRA, but settlement sizes have increased—reflecting, in their view, a higher proportion of meritorious litigation.[205]

Proponents further note that such trends have prompted securities experts to surmise that PSLRA's reforms may be preventing meritorious claims from being filed.[206] They point out that Congress has limited the use of class action lawsuits for securities fraud to federal courts instead of state courts. In 1998, Congress enacted SLUSA to address the concern that securities fraud lawsuits had shifted from federal to state courts as a means of circumventing PSLRA. Additionally, proponents note that a private right of action for aiding and abetting existed for decades before *Central Bank* and the passage of PSLRA, and secondary actors at that time did not experience a high volume of non-meritorious lawsuits. Finally, proponents say that such a private right of action would protect the integrity and enhance the competitiveness of U.S. financial markets because it would promote transparency and good corporate governance.

According to opponents, creating a private right of action for aiding and abetting would exacerbate the impediment that class action lawsuits pose to economic growth in the United States. Opponents note that the risk of

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[204] For a summary of PSLRA's reforms and analyses of their effectiveness, *see* Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes during the First Decade after the PSLRA*, 106 COLUM. L. REV. 1489 (2006).

[205] *See, e.g.*, TODD FOSTER, RONALD I. MILLER, & STEPHANIE PLANCICH, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: FILINGS PLUMMET, SETTLEMENTS SOAR (2007).

[206] *See, e.g.*, Stephen J. Choi, Karen K. Nelson, & A.C. Pritchard, *The Screening Effect of the Private Securities Litigation Reform Act*, 35-68 (U. of Mich. L. & Econ., Olin Working Paper No. 07-008, 2007).

securities fraud litigation already has caused some foreign companies to choose not to do business with U.S. companies to avoid a higher litigation risk. Alternatively, business partners could take steps to mitigate such risk, such as by insuring themselves against the risk or charging companies higher prices for their services. However, opponents note that any such approach would increase the cost of doing business with a publicly held company and, in turn, the cost of being a publicly held company. Opponents also contend that the higher costs imposed on U.S. publicly traded companies because of securities fraud litigation risk would discourage U.S. and foreign firms from listing or remaining listed on U.S. securities exchanges or raising capital in the United States. Opponents maintain that the U.S. capital markets are losing their competitiveness with foreign markets, in part evidenced by their lower growth rate and creation of fewer new companies relative to foreign markets.[207]

D. Possible Measures That Might Mitigate Potential Negative Effects

At least one legal expert has suggested that if Congress were to create private aiding and abetting liability, it could mitigate the potential adverse effects of such actions by placing a ceiling on liability for secondary actor defendants. This would be particularly appropriate for secondary actors such as accountants or other professionals.[208] This expert noted that a liability ceiling could be beneficial, in part because gatekeepers can be deterred more easily, given that they stand to make only a small portion of the gain from fraud that a primary actor expects and the failure of a gatekeeper could be as disruptive to the capital markets when gatekeeper services are highly concentrated. The expert further noted that a ceiling on damages would not only permit gatekeepers that currently cannot obtain liability insurance to obtain such coverage, thus averting their potential collapse, but also protect gatekeepers from feeling pressure to settle by the threat of potential astronomical damages if found liable at trial.

According to this expert, the goal of the liability ceiling would be to devise a penalty that is sufficient to deter aiding and abetting by secondary actors but not so large as to threaten their insolvency. Because some secondary actors are publicly held companies and some are not, a variety of measures should be used to set the amount of the ceiling: for example, market capitalization or net worth for public companies, and revenues or income for private ones. A ceiling may be necessary so that companies are not subject to unlimited liability. In brief, the expert proposed that the ceiling be set at $2 million for a natural person and $50 million for a public corporation, noting that the real

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[207] *See, e.g.*, MCKINSEY & COMPANY, SUSTAINING NEW YORK'S AND THE U.S.'S GLOBAL FINANCIAL SERVICES LEADERSHIP (2006) (report commissioned by Mayor Michael R. Bloomberg & Senator Charles E. Schumer); COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT (2006).

[208] John C. Coffee, Jr., Testimony Before the Subcommittee on Crime and Drugs of the Committee on the Judiciary of the U.S. Senate, Sep. 17, 2009.

impact of a ceiling is to induce the parties to settle for an amount below the ceiling.

Another legal expert opposed to creating private aiding and abetting liability has suggested limiting the damages available in Rule 10b-5 fraud-on-the-market cases to focus on deterrence rather than compensation.[209] This expert noted that instead of making defendants liable for all losses resulting from fraud, defendants should be forced to disgorge their gains (or expected gains, for those who fail in their scheme) from the fraud. According to this expert, in most fraud-on-the-market cases, the corporation does not benefit from the fraud but rather is the victim of the fraud, such as when an executive is awarded an undeserved bonus by creating the appearance of meeting the target stock price. This expert noted that under a disgorgement rule, the proper remedy would be for the executive to return the bonus earned from the fraud to the corporation. According to this expert, if Congress were to adopt a disgorgement measure of damages for Rule 10b-5 class actions, plaintiffs' lawyers would have to settle with executives instead of corporations or secondary defendants. Under this approach, secondary actors complicit in a corporation's fraud would be forced to give up their fees (or some multiple thereof) earned during the fraud period. Other proposals suggested by legal experts in connection with aiding and abetting liability to private investors involve how liability is imposed. Under current law, proportionate liability (liability based on the percentage of responsibility) generally applies where the defendant does not act knowingly. If the person knowingly violates the securities laws, liability can be joint and several (each defendant potentially can bear the total damages). These legal experts propose creating aiding and abetting liability but limiting potential liability to proportionate liability for secondary actors shown to have actual knowledge of the wrongdoing or who demonstrate intent to defraud.

CONCLUSION

Legislation and court decisions over the past two decades have dramatically altered the scope of private securities fraud liability for secondary actors, as well as the requirements for litigating all types of private securities fraud class actions. Debate continues over whether a private cause of action for aiding and abetting securities fraud should be created, centering on whether this would enhance deterrence of securities fraud, promote equitable compensation of injured investors, and affect the U.S. economy and corporate governance.

[209] Adam C. Pritchard, Testimony before the Subcommittee on Crime and Drugs of the Committee on the Judiciary of the U.S. Senate, Sep. 17, 2009.

We are sending copies of this analysis to interested congressional committees and to the Chairman of the Securities and Exchange Commission and the Attorney General. In addition, this analysis will be available at no charge on GAO's website at http://www.gao.gov.

If you or your staff have questions about this analysis, please contact Susan D. Sawtelle at (202) 512-6417 or SawtelleS@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs are: Ralph Dawn, Managing Director, Congressional Relations, (202) 512-4400 or DawnR@gao.gov; and Chuck Young, Managing Director, Public Affairs, at (202) 512-4800 or YoungC1@gao.gov. The following persons made key contributions to this analysis: Orice Williams Brown, Managing Director, Financial Institutions and Markets; Assistant General Counsel Rachel M. DeMarcus; Assistant Directors Richard S. Tsuhara and Francis L. Dymond; Patrick S. Dynes; Lauren S. Fassler; Nina Horowitz; Daniel S. Kaneshiro; Marc W. Molino; and Patricia A. Moye.

Susan D. Sawtelle
Managing Associate General Counsel

Enclosure I

Scope and Methodology of this Analysis

To conduct this analysis, we reviewed the securities laws and regulations that provide for a right of action for private plaintiffs for violations of the securities laws. We focused on the evolution of the implied private right of action under section 10(b) of the 1934 Act and SEC Rule 10b-5 against persons who commit fraud in connection with the purchase or sale of securities. We also reviewed sources that discuss the roles of various financial market participants such as public companies, investment banks, accountants, lawyers, and vendors. We reviewed relevant federal legislation including the Private Securities Litigation Reform Act of 1995 (PSLRA), the Securities Litigation Uniform Standards Act of 1998 (SLUSA), the Sarbanes-Oxley Act of 2002, and the Dodd-Frank Wall Street Reform and Consumer Protection Act. We reviewed key Supreme Court decisions, including the *Central Bank* decision in 1994, the *Stoneridge* decision in 2008, and the *Janus* decision in 2011, concerning the types of claims that can be brought against secondary actors under section 10(b) of the 1934 Act, as well as other relevant federal court decisions. We reviewed the briefs filed with the Supreme Court by the parties and other interested entities in the *Central Bank* and *Stoneridge* cases and interviewed a number of these entities. We also reviewed relevant law review articles and court decisions on the scope of the implied private right of action under section 10(b). Further, we reviewed key court decisions and articles interpreting PSLRA and SLUSA since their enactment in the mid-1990s. Finally, we interviewed representatives from a broad range of organizations to obtain their input and perspectives on the potential implications of authorizing a private right of action for aiding and abetting, including the Securities and Exchange Commission; the Department of Justice; consumer, corporate, accounting, and securities associations; and companies and individuals that participated in the *Central Bank* and *Stoneridge* litigation. We provided a copy of the draft report to the Department of Justice and the Securities and Exchange Commission for review and comment. The Securities and Exchange Commission provided technical comments that we incorporated as appropriate; the Department of Justice did not provide comments.