SECURITIES REGULATION

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PRIMARY ISSUER TRANSACTIONAL EXEMPTIONS FROM REGISTRATION

§ 3.06 RULE 506 OF REGULATION D

[A] Traditional Rule 506

Page 113 add:

"Bad Actor" Disqualifiers

In 2013, implementing the directive set forth in the Dodd-Frank Act, the SEC adopted "bad actor" disqualifiers for Rule 506 offerings. Rule 506(d), the bad actor disqualification provision, resembles the bad actor disqualifiers that have been a component of the Regulation A exemptive framework for decades. Disqualifying events (that preclude the subject issuer from using the Rule 506 exemption for five or ten years depending on the type of the misconduct) include specified criminal conduct and court injunctions, SEC disciplinary orders (including cease and desist orders), enforcement orders from other regulators (such as state securities regulators, federal banking agencies, and the CFTC), and suspensions or expulsions issued by a self-regulatory organization (SRO). The disqualification provision of Rule 506(d) encompasses: (1) the issuer (including its predecessors and affiliated enterprises); (2) the issuer's directors and certain officers (as well as its general partners and managing members); (3) the issuer's beneficial owners of 20% or more of its stock or other equitable ownership interest (*e.g.,* limited partnership units); (4) promoters; (5) investment managers; and (6) individuals or enterprises that for compensation solicit investors (including general partners, officers, directors, and managing members of such compensated solicitor).

Rule 506(d) does provide an exception when the issuer can establish that it did not know and, in its exercise of reasonable care, could not have known that a disqualified person who had engaged in disqualifying conduct participated in the offering. Moreover, upon a showing of good cause, the Commission may waive the Rule 506(d) disqualification.

[B] JOBS ACT – Rule 506

page 117 add:

The meaning of an issuer's obligations to take reasonable steps to *verify* that all purchasers are accredited is crucial. In this regard, it is imperative that an issuer (or its agents) maintain adequate records that set forth the "reasonable steps [taken] to verify" that a subject purchaser in fact is an accredited investor.

To elaborate, the use of general solicitation in Rule 506 offerings requires issuers "to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission."[1] In 2013, the SEC engaged in rulemaking pursuant to this directive.[2] The objective of the verification requirement is to minimize the risk that the use of general solicitation in Rule 506 offerings will result in the sale of securities to nonaccredited investors. As set forth by the Commission, whether the steps undertaken by an issuer are "reasonable" is an objective determination based on the particular facts and circumstances of the transaction and the subject purchaser. Adhering to a "principles-based method of verification," the SEC stated that issuers should consider the following factors to meet their reasonable verification obligation under Rule 506(c):

> [1] the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
>
> [2] the amount and type of information that the issuer has about the purchaser; and
>
> [3] the nature of the offering, such as the manner in which the purchaser was solicited in the offering, and the terms of the offering, such as a minimum investment amount.[3]

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1 Section 201(a) of the JOBS Act; Rule 506(c) of Regulation D.
2 Securities Act Release No. 9415 (2013).
3 *Id.*

As stated by the Commission, the foregoing factors are interconnected – the more likely a purchaser reasonably appears to qualify as an accredited investor, the fewer steps an issuer would be required to take to verify accredited status, and vice versa. For example, "if the terms of the offering require a high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor may be sufficiently high such that, absent any facts that indicate that the purchaser is not an accredited investor, it may be reasonable for the issuer to take fewer steps to verify. . . ."[4] Regardless of the particular steps an issuer takes, because it is the issuer's burden to establish that it has perfected an exemption from Securities Act registration, it is important that issuers (or their agents) retain adequate documentation regarding the steps undertaken with respect to verification of accredited investor status.[5]

With respect to accredited investor status for a natural person, the Commission adopted specific non-exclusive methods of verifying his/her accredited investor status (conducted within the prior three months).[6] First, with respect to verification of a natural person as an accredited investor based on his/her income, an issuer is deemed to satisfy the verification requirement by reviewing any Internal Revenue Service (IRS) form that reports the income of such individual

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[4] *Id.*

[5] *Id.*

[6] *Id.* Note that "none of these methods will be deemed to satisfy the verification requirement if the issuer or its agent has knowledge that the purchaser is not an accredited investor." *Id.*

and obtaining a written representation from such individual that he/she reasonably expects to reach the requisite individual (or joint spousal) income during the current year.[7]

Second, to verify that a natural person is an accredited investor based on such investor's net worth, an issuer should review documentation of the investor's assets, such as bank statements, brokerage statements, certificates of deposit, and appraisal reports issued by an independent third party. Liabilities also must be assessed, including a consumer (i.e., credit) report from a nationwide consumer reporting agency.[8]

Third, another avenue by which an issuer may satisfy the verification requirement in Rule 506(c) is to obtain a written confirmation from the subject investor's attorney, certified public accountant, registered broker-dealer, or registered investment adviser that such person has taken reasonable steps to verify within the prior three months and has determined that the investor has accredited status.[9]

The Commission emphasized that the foregoing three methods are non-exclusive. Importantly, this requirement of verification in Rule 506 offerings where an issuer engages in general solicitation is "separate from and independent

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[7] *Id.*
[8] *Id.*
[9] *Id.*

of the requirement that sales be limited to accredited investors . . . [In other words,] the reasonable verification requirement mandated by Rule 506(c) must be satisfied even if all purchasers happen to be accredited investors."[10]

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§ 3.07 THE LIMITED OFFERING EXEMPTIONS

[D] Regulation A

Page 125 add:

ADOPTION OF REGULATION A AMENDMENTS

SEC News Release 2015-49 (2015)

The new rules update and expand Regulation A, an existing exemption from registration for smaller issuers of securities. The rules are mandated by Title IV of the Jumpstart Our Business Startups (JOBS) Act.

The updated exemption will enable smaller companies to offer and sell up to $50 million of securities in a 12-month period, subject to eligibility, disclosure and reporting requirements.

. . . .

The final rules, often referred to as Regulation A+, provide for two tiers of offerings: *Tier 1*, for offerings of securities of up to $20 million in a 12-month

[10] *Id.* A number of sources have criticized the SEC's 2013 rule adoption, asserting that the verification directive as promulgated unduly impairs the raising of capital. See, e.g., Verrill, *SEC Rules Will Clip the Wings of Angel Investors,* Wall St. J., July 25, 2013, at A11.

period, with not more than $6 million in offers by selling security-holders that are affiliates of the issuer; and *Tier 2*, for offerings of securities of up to $50 million in a 12-month period, with not more than $15 million in offers by selling security-holders that are affiliates of the issuer. Both Tiers are subject to certain basic requirements while Tier 2 offerings are also subject to additional disclosure and ongoing reporting requirements.

The final rules also provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to “qualified purchasers” in Tier 2 offerings. Tier 1 offerings will be subject to federal and state registration and qualification requirements, and issuers may take advantage of the coordinated review program developed by the North American Securities Administrators Association (NASAA).

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Fact Sheet

Regulation A+

March 25, 2015

Background

Under the Securities Act of 1933, when a company sells securities to potential investors, it must either register the sale or rely on an exemption from registration. Regulation A is a longstanding exemption from registration that permits unregistered public offerings of up to $5 million of securities in any 12-month period, including no more than $1.5 million of securities offered by security-holders of the company. In recent years, Regulation A offerings have been relatively rare in comparison to offerings conducted in reliance on other Securities Act exemptions or on a registered basis.

The JOBS Act amended the Securities Act to require the Commission to update and expand the Regulation A exemption. In particular, the JOBS Act directed the Commission to:

- Adopt rules that would allow offerings of up to $50 million of securities within a 12-month period.
- Require companies conducting such offerings to file annual audited financial statements with the SEC.
- Adopt additional requirements and conditions that the Commission determines necessary.

. . . .

Highlights of the Final Rules

The final rules, often referred to as Regulation A+, . . . provide for two tiers of offerings:

- *Tier 1*, which would consist of securities offerings of up to $20 million in a 12-month period, with not more than $6 million in offers by selling security-holders that are affiliates of the issuer.
- *Tier 2*, which would consist of securities offerings of up to $50 million in a 12-month period, with not more than $15 million in offers by selling security-holders that are affiliates of the issuer.

In addition to the limits on secondary sales by affiliates, the rules also limit sales by all selling security-holders to no more than 30 percent of a particular offering in the issuer's initial Regulation A offering and subsequent Regulation A offerings for the first 12 months following the initial offering.

For offerings of up to $20 million, the issuer could elect whether to proceed under Tier 1 or Tier 2. Both tiers would be subject to basic requirements as to issuer eligibility, disclosure, and other matters, drawn from the current provisions of Regulation A. Both tiers would also permit companies to submit draft offering statements for non-public review by Commission staff before filing, permit the continued use of solicitation materials after filing the offering statement, require the electronic filing of offering materials and otherwise align Regulation A with current practice for registered offerings.

Additional Tier 2 Requirements

In addition to these basic requirements, companies conducting Tier 2 offerings would be subject to other requirements, including:

- A requirement to provide audited financial statements.
- A requirement to file annual, semiannual and current event reports.
- A limitation on the amount of securities non-accredited investors can purchase in a Tier 2 offering of no more than 10 percent of the greater of the investor's annual income or net worth.

The staff would also conduct a study and submit a report to the Commission on the impact of both the Tier 1 and Tier 2 offerings on capital formation and investor protection no later than five years following the adoption of the amendments to Regulation A.

The Commission is exploring ways to further collaborate with state regulators, including a program for a representative of NASAA or a state securities regulator to work with the staff in the SEC's Division of Corporation Finance in implementing these rules.

Eligibility

The exemption would be limited to companies organized in and with their principal place of business in the United States or Canada. The exemption would not be available to companies that:

- Are already SEC reporting companies and certain investment companies.

- Have no specific business plan or purpose or have indicated their business plan is to engage in a merger or acquisition with an unidentified company.
- Are seeking to offer and sell asset-backed securities or fractional undivided interests in oil, gas or other mineral rights.
- Have been subject to any order of the Commission under Exchange Act Section 12(j) [suspending or revoking the registration of a security] entered within the past five years.
- Have not filed ongoing reports required by [SEC] rules during the preceding two years.
- Are disqualified under the "bad actor" disqualification rules.

The rules exempt securities in a Tier 2 offering from the mandatory registration requirements of Exchange Act Section 12(g) if the issuer meets all of the following conditions:

- Engages services from a transfer agent registered with the Commission.
- Remains subject to a Tier 2 reporting obligation.
- Is current in its annual and semiannual reporting at fiscal year-end.
- Has a public float of less than $75 million as of the last business day of its most recently completed semiannual period, or, in the absence

of a public float, had annual revenues of less than $50 million as of its most recently completed fiscal year.

An issuer that exceeds the dollar and Section 12(g) registration thresholds would have a two-year transition period before it must register its class of securities, provided it timely files all of its ongoing reports required under Regulation A.

Preemption of Blue Sky Law

In light of the total package of investor protections included in amended Regulation A, the rules provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to "qualified purchasers," defined to be any person to whom securities are offered or sold under a Tier 2 offering.

Also informative is the following SEC Release adopting amendments to Regulation A.

Securities Act Release No. 9741 (2015)

We are adopting final rules to implement the JOBS Act mandate by expanding Regulation A into two tiers: *Tier 1*, for securities offerings of up to $20 million; and *Tier 2*, for offerings of up to $50 million. [Note then an issuer of $20 million or less of securities may elect to use either Tier 1 or Tier 2.] The final rules for offerings under Tier 1 and Tier 2 build on current Regulation A and preserve, with some modifications, existing provisions regarding issuer eligibility, offering circular contents, testing the waters, and "bad actor" disqualification. As proposed, and with the modifications described below, the final rules modernize the Regulation A filing process for all offerings, align practice in certain areas with prevailing practice for registered offerings, create additional flexibility for issuers in the offering process, and establish an ongoing reporting regime for Regulation A issuers. Under the final rules, Tier 2 issuers are required to include audited financial statements in their offering documents and to file annual, semiannual, and current reports with the Commission. With the exception of securities that will be listed on a national securities exchange upon qualification, purchasers in Tier 2 offerings must either be accredited investors, as that term is defined in Rule 501(a) of Regulation D, or be subject to certain limitations on their investment. The differences between Tier 1 and Tier 2 offerings are described more fully below.

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The key provisions of the final rules and amendments to Regulation A follow:

Scope of the exemption – the final rules:

- Establish two tiers of offerings:

- *Tier 1*: annual offering limit of $20 million, including no more than $6 million on behalf of selling securityholders that are affiliates of the issuer.
- *Tier 2*: annual offering limit of $50 million, including no more than $15 million on behalf of selling securityholders that are affiliates of the issuer.

- Limit sales by selling securityholders in an issuer's initial Regulation A offering and any subsequently qualified Regulation A offering within the first 12-month period following the date of qualification of the initial Regulation A offering to no more than 30% of the aggregate offering price.
- Preserve the existing issuer eligibility requirements of Regulation A, and also exclude issuers that are, or have been, subject to any order of the Commission [suspending or revoking the registration of a security] pursuant to Section 12(j) of the Exchange Act entered within five years before the filing of the offering statement and issuers that are required to, but that have not, filed with the Commission the ongoing reports required by the final rules during the two years immediately preceding the filing of an offering statement.
- Limit the amount of securities that an investor who is not an accredited investor under Rule 501(a) of Regulation D can purchase in a Tier 2 offering

to no more than: (a) 10% of the greater of annual income or net worth (for natural persons); or (b) 10% of the greater of annual revenue or net assets at fiscal year end (for non-natural persons). This limit will not apply to purchases of securities that will be listed on a national securities exchange upon qualification.

- Exclude asset-backed securities, as defined in Regulation AB, from the list of eligible securities.
- Update the safe harbor from integration and provide guidance on the potential integration of offerings conducted concurrently with, or close in time after, a Regulation A offering.

Solicitation materials:

- Permit issuers to "test the waters" with, or solicit interest in a potential offering from, the general public either before or after the filing of the offering statement, so long as any solicitation materials used after publicly filing the offering statement are preceded or accompanied by a preliminary offering circular or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained.

Qualification, communications, and offering process:

- Require issuers and intermediaries in the prequalification period to deliver a preliminary offering circular to prospective purchasers at least 48 hours in advance of sale unless the issuer is subject to, and current in, Tier 2 ongoing reporting obligations. Where the issuer is subject to, and current in, a Tier 2 ongoing reporting obligation, issuers and intermediaries will only be required to comply with the general delivery requirements for offers.

- Modernize the qualification, communications, and offering processes in Regulation A to reflect analogous provisions of the Securities Act registration process:
  - Permit issuers and intermediaries to satisfy their delivery requirements as to the final offering circular under an "access equals delivery" model when sales are made on the basis of offers conducted during the prequalification period and the final offering circular is filed and available on the Commission's Electronic Data Gathering, Analysis and Retrieval system (EDGAR);
  - Require issuers and intermediaries, not later than two business days after completion of a sale, to provide purchasers with a copy of the final offering circular or a notice with the uniform resource locator (URL) where the final offering circular may be obtained on EDGAR and contact information sufficient to notify a purchaser where a request for a final offering circular can be sent and received in response; and

    - Permit issuers to file offering circular updates and supplements after qualification of the offering statement in lieu of post-qualification amendments in certain circumstances, including to provide the types of information that may be excluded from a prospectus under Rule 430A.

- Permit continuous or delayed offerings, but require issuers in continuous or delayed Tier 2 offerings to be current in their annual and semiannual reporting obligations in order to do so.
- Permit issuers to qualify additional securities in reliance on Regulation A by filing a post-qualification amendment to a qualified offering statement.

Offering statement:

- Require issuers to file offering statements with the Commission electronically on EDGAR.
- Permit the non-public submission of offering statements and amendments for review by Commission staff before filing such documents with the Commission, so long as all such documents are publicly filed not later than 21 calendar days before qualification.
- Eliminate the Model A (Question-and-Answer) disclosure format under Part II of Form 1-A.

- Update and clarify Model B (Narrative) disclosure format under Part II of Form 1-A (renamed, "Offering Circular"), while continuing to permit Part I of Form S-1 narrative disclosure as an alternative.

. . . .

- Require that offering statements be qualified by the Commission before sales may be made pursuant to Regulation A.
- Require Tier 1 and Tier 2 issuers to file balance sheets and related financial statements for the two previous fiscal year ends (or for such shorter time that they have been in existence).
- Require Tier 2 issuers to include financial statements in their offering circulars that are audited in accordance with either the auditing standards of the American Institute of Certified Public Accountants (AICPA) (referred to as U.S. Generally Accepted Auditing Standards or GAAS) or the standards of the Public Company Accounting Oversight Board (PCAOB).
- Require Tier 1 and Tier 2 issuers to include financial statements in Form 1-A that are dated not more than nine months before the date of non-public submission, filing, or qualification, with the most recent annual or interim balance sheet not older than nine months. If interim financial statements are required, they must cover a period of at least six months.

Ongoing reporting:

- Require Tier 1 issuers to provide information about sales in such offerings and to update certain issuer information by electronically filing a Form 1-Z exit report with the Commission not later than 30 calendar days after termination or completion of an offering.
- Require Tier 2 issuers to file electronically with the Commission on EDGAR annual and semiannual reports, as well as current event reports.
- Require Tier 2 issuers to file electronically a special financial report to cover financial periods between the most recent period included in a qualified offering statement and the issuer's first required periodic report.
- Permit the ongoing reports filed by an issuer conducting a Tier 2 offering to satisfy a broker-dealer's obligations under Exchange Act Rule 15c2-11.
- Provide that Tier 2 issuers' reporting obligations under Regulation A would suspend when they are subject to the ongoing reporting requirements of Section 13 of the Exchange Act, and may also be suspended under Regulation A at any time by filing a Form 1-Z exit report after completing reporting for the fiscal year in which an offering statement was qualified, so long as the securities of each class to which the offering statement relates are held of record by fewer than 300 persons, or fewer than 1,200 persons for banks or bank holding companies, and offers or sales made in reliance on a qualified Tier 2 Regulation A offering statement are not ongoing. In certain

circumstances, Tier 2 Regulation A reporting obligations may terminate when issuers are no longer subject to the ongoing reporting requirements of Section 13 of the Exchange Act.

- Require Tier 2 issuers to include in their first annual report after termination or completion of a qualified Regulation A offering, or in their Form 1-Z exit report, information about sales in the terminated or completed offering and to update certain issuer information.

. . . .

Exchange Act registration:

- Conditionally exempt securities issued in a Tier 2 offering from the mandatory registration requirements of Section 12(g) of the Exchange Act, for so long as the issuer engages the services of a transfer agent that is registered with the Commission under Section 17A of the Exchange Act, remains subject to a Tier 2 reporting obligation, is current in its annual and semiannual reporting at fiscal year end, and had a public float of less than $75 million as of the last business day of its most recently completed semiannual period, or, in the absence of a public float, had annual revenues of less than $50 million as of its most recently completed fiscal year.
- Permit Tier 2 issuers to use a Form 8-A short form registration statement concurrently with the qualification of a Regulation A offering statement that

includes Part 1 of Form S-1 or Form S-11 narrative disclosure in Form 1-A in order to register a class of securities under Sections 12(g) or 12(b) of the Exchange Act.

"Bad actor" disqualification provisions:

- Substantially conform the "bad actor" disqualification provisions of Rule 262 to Rule 506(d) and add a disclosure requirement similar to Rule 506(e).

Application of state laws:

- Provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to "qualified purchasers," in light of the total package of investor protections included in the final rules. A qualified purchaser will be defined to be any person to whom securities are offered or sold in a Tier 2 offering.

The Commission is required by Section 3(b)(5) of the Securities Act to review the Tier 2 offering limitation every two years. In addition to revisiting the Tier 2 offering limitation, the staff will also undertake to review the Tier 1 offering limitation at the same time. The staff also will undertake to study and submit a report to the Commission no later than 5 years following the adoption of the amendments to Regulation A, on the impact of both the Tier 1 and Tier 2 offerings on capital formation and investor protection. The report will include, but not be limited to, a review of: (1) the amount of capital raised under the amendments; (2)

the number of issuances and amount raised by both Tier 1 and Tier 2 offerings; (3) the number of placement agents and brokers facilitating the Regulation A offerings; (4) the number of Federal, State, or any other actions taken against issuers, placement agents, or brokers with respect to both Tier 1 and Tier 2 offerings; and (5) whether any additional investor protections are necessary for either Tier 1 or Tier 2. Based on the information contained in the report, the Commission may propose to either decrease or increase the offering limit for Tier 1, as appropriate.

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Chapter 7

DUE DILIGENCE AND SECURITIES ACT LIABILITY

§ 7.02 The Registered Offering — Framework of Section 11

[B] Elements of the § 11 Right of Action

Page 364 add:

OMNICARE, INC. v. LABORERS DISTRICT COUNCIL CONSTRUCTION INDUSTRY PENSION FUND

United States Supreme Court

135 S. Ct. 1318 (2015)

Justice KAGAN delivered the opinion of the Court.

Before a company may sell securities in interstate commerce, it must file a registration statement with the Securities and Exchange Commission (SEC). If that document either "contain[s] an untrue statement of a material fact" or "omit[s] to state a material fact . . . necessary to make the statements therein not misleading," a purchaser of the stock may sue for damages. [Section 11(a) of the Securities Act,] 15 U.S.C. § 77k(a). This case requires us to decide how each of those phrases applies to statements of opinion.

I.

The Securities Act of 1933 protects investors by ensuring that companies issuing securities (known as "issuers") make a "full and fair disclosure of information" relevant to a public offering. The linchpin of the Act is its registration requirement. With limited exceptions not relevant here, an issuer may offer securities to the public only after filing a registration statement. That statement must contain specified information about both the company itself and the security for sale. Beyond those required disclosures, the issuer may include additional representations of either fact or opinion.

Section 11 of the Act promotes compliance with these disclosure provisions by giving purchasers a right of action against an issuer or designated individuals (directors, partners, underwriters, and so forth) for material misstatements or omissions in registration statements. As relevant here, that section provides:

> "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . [may] sue."

Section 11 thus creates two ways to hold issuers liable for the contents of a registration statement—one focusing on what the statement says and the other on what it leaves out. Either way, the buyer need not prove (as he must to establish certain other securities offenses) that the defendant acted with any intent to deceive or defraud.

This case arises out of a registration statement that petitioner Omnicare filed in connection with a public offering of common stock. Omnicare is the nation's largest provider of pharmacy services for residents of nursing homes. Its registration statement contained (along with all mandated disclosures) analysis of the effects of various federal and state laws on its business model, including its acceptance of rebates from pharmaceutical manufacturers. Of significance here, two sentences in the registration statement expressed Omnicare's view of its compliance with legal requirements:

- "We believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws."
- "We believe that our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the healthcare system and the patients that we serve."

Accompanying those legal opinions were some caveats. On the same page as the first statement above, Omnicare mentioned several state-initiated "enforcement actions against pharmaceutical manufacturers" for offering payments to pharmacies that dispensed their products; it then cautioned that the laws relating to that practice might "be interpreted in the future in a manner inconsistent with our interpretation and application." And adjacent to the second statement, Omnicare noted that the Federal Government had expressed "significant concerns" about some manufacturers' rebates to pharmacies and warned that business might suffer "if these price concessions were no longer provided."

Respondents here, pension funds that purchased Omnicare stock in the public offering (hereinafter Funds), brought suit alleging that the company's two opinion statements about legal compliance give rise to liability under § 11. Citing lawsuits that the Federal Government later pressed against Omnicare, the Funds' complaint maintained that the company's receipt of payments from drug manufacturers violated anti-kickback laws. Accordingly, the complaint asserted, Omnicare made "materially false" representations about legal compliance. And so too, the complaint continued, the company "omitted to state [material] facts necessary" to make its representations not misleading. The Funds claimed that none of Omnicare's officers and directors "possessed reasonable grounds" for thinking that the opinions offered were truthful and complete. Indeed, the complaint noted that one of Omnicare's attorneys had warned that a particular contract "carrie[d] a heightened risk" of liability under anti-kickback laws. At the same time, the Funds made clear that in light of § 11's strict liability standard, they chose to “exclude and disclaim any allegation that could be construed as alleging fraud or intentional or reckless misconduct.”

The District Court granted Omnicare’s motion to dismiss. In the court’s view, “statements regarding a company’s belief as to its legal compliance are considered ‘soft’ information” and are actionable only if those who made them “knew [they] were untrue at the time.” The court concluded that the Funds’ complaint failed to meet that standard because it nowhere claimed that “the company’s officers knew they were violating the law.” The Court of Appeals for the Sixth Circuit [in an opinion written by the Honorable Guy Cole] reversed. See 719 F.3d 498 (2013). It acknowledged that the two statements highlighted in the Funds’ complaint expressed Omnicare’s “opinion” of legal compliance, rather than “hard facts.” But even so, the court held, the Funds had to allege only that the stated belief was “objectively false”; they did not need to contend that anyone at Omnicare “disbelieved [the opinion] at the time it was expressed.” . . .

We granted certiorari to consider how § 11 pertains to statements of opinion. We do so in two steps, corresponding to the two parts of § 11 and the two theories in the Funds’ complaint. We initially address the Funds’ claim that Omnicare made “untrue statement[s] of . . . material fact” in offering its views on legal compliance. We then take up the Funds’ argument that Omnicare “omitted to state a material fact . . . necessary to make the statements [in its registration filing] not misleading." Unlike both courts below, we see those allegations as presenting different issues. In resolving the first, we discuss when an opinion itself constitutes a factual misstatement. In analyzing the second, we address when an opinion may be rendered misleading by the omission of discrete factual representations. Because we find that the Court of Appeals applied the wrong standard, we vacate its decision.

II.

The Sixth Circuit held, and the Funds now urge, that a statement of opinion that is ultimately found incorrect—even if believed at the time made—may count as an "untrue statement of a material fact." As the Funds put the point, a statement of belief may make an implicit assertion about the belief's "subject matter". To say "we believe X is true" is often to indicate that "X is in fact true." In just that way, the Funds conclude, an issuer's statement that "we believe we are following the law" conveys that "we in fact are following the law"—which is "materially false," no matter what the issuer thinks, if instead it is violating an anti-kickback statute.

But that argument wrongly conflates facts and opinions. A fact is "a thing done or existing" or "[a]n actual happening." Webster's New International Dictionary 782 (1927). An opinion is "a belief[,] a view," or a "sentiment which the mind forms of persons or things." *Id*., at 1509. Most important, a statement of fact ("the coffee is hot") expresses certainty about a thing, whereas a statement of opinion ("I think the coffee is hot") does not. See *ibid*. ("An opinion, in ordinary usage . . . does not imply . . . definiteness . . . or certainty"); 7 Oxford English Dictionary 151 (1933) (an opinion "rests[s] on grounds insufficient for complete demonstration"). Indeed, that difference between the two is so ingrained in our everyday ways of speaking and thinking as to make resort to old dictionaries seem a mite silly. And Congress effectively incorporated just that distinction in § 11's first part by exposing issuers to liability not for "untrue statement[s]" full stop (which would have included ones of opinion), but only for "untrue statement[s] of . . . *fact*."

Consider that statutory phrase's application to two hypothetical statements, couched in ways the Funds claim are equivalent. A company's CEO states: "The TVs we manufacture have the highest resolution available on the market." Or, alternatively, the CEO transforms that factual statement into one of opinion. "I *believe*" (or "I think") "the TVs we manufacture have the highest resolution available on the market." The first version would be an untrue statement of fact if a competitor had introduced a higher resolution TV a month before—even assuming the CEO had not yet learned of the new product. The CEO's assertion, after all, is not mere puffery, but a determinate, verifiable statement about her company's TVs; and the CEO, however innocently, got the facts wrong. But in the same set of circumstances, the second version would remain true. Just as she said, the CEO really did believe, when she made the statement, that her company's TVs had the sharpest picture around. And although a plaintiff could later prove that opinion erroneous, the words "I believe" themselves admitted that possibility, thus precluding liability for an untrue statement of fact. That remains the case if the CEO's opinion, as here, concerned legal compliance. If, for example, she said, "I believe our marketing practices are lawful," and actually did think that, she could not be liable for a false statement of fact—even if she afterward discovered a longtime violation of law. Once again, the statement would have been true, because all she expressed was a view, not a certainty, about legal compliance.

That still leaves some room for § 11's false-statement provision to apply to expressions of opinion. As even Omnicare acknowledges, every such statement explicitly affirms one fact: that the speaker actually holds the stated belief. See Brief for Petitioners 15-16; W. Keeton, D. Dobbs, R. Keeton, & D. Owen, Prosser and Keeton on the Law of Torts § 109, p. 755 (5th ed. 1984) (Prosser and Keeton) ("[A]n expression of opinion is itself always a statement of . . . the fact of the belief, the existing state of mind, of the one who asserts it"). For that reason, the CEO's statement about product quality ("I believe our TVs have the highest resolution available on the market") would be an untrue statement of fact—

namely, the fact of her own belief—if she knew that her company's TVs only placed second. And so too the statement about legal compliance ("I believe our marketing practices are lawful") would falsely describe her own state of mind if she thought her company was breaking the law. In such cases, § 11's first part would subject the issuer to liability (assuming the misrepresentation were material).

In addition, some sentences that begin with opinion words like "I believe" contain embedded statements of fact . . . . Suppose the CEO in our running hypothetical said: "I believe our TVs have the highest resolution available because we use a patented technology to which our competitors do not have access." That statement may be read to affirm not only the speaker's state of mind, as described above, but also an underlying fact: that the company uses a patented technology. . . . Accordingly, liability under § 11's false-statement provision would follow (once again, assuming materiality) not only if the speaker did not hold the belief she professed but also if the supporting fact she supplied were untrue.

But the Funds cannot avail themselves of either of those ways of demonstrating liability. The two sentences to which the Funds object are pure statements of opinion: To simplify their content only a bit, Omnicare said in each that "we believe we are obeying the law." And the Funds do not contest that Omnicare's opinion was honestly held. Recall that their complaint explicitly “exclude[s] and disclaim[s]” any allegation sounding in fraud or deception. What the Funds instead claim is that Omnicare’s belief turned out to be wrong—that whatever the company thought, it was in fact violating anti-kickback laws. But that allegation alone will not give rise to liability under § 11’s first clause because, as we have shown, a sincere statement of pure opinion is not an “untrue statement of material fact,” regardless whether an investor can ultimately prove the belief wrong. That clause, limited as it is to factual statements, does not allow investors to second-guess inherently subjective and uncertain assessments. In other words, the provision is not . . . an invitation to Monday morning quarterback an issuer’s opinions.

III.

A

That conclusion, however, does not end this case because the Funds also rely on § 11’s omissions provision, alleging that Omnicare “omitted to state facts necessary” to make its opinion on legal compliance “not misleading.” As all parties accept, whether a statement is “misleading” depends on the perspective of a reasonable investor: The inquiry (like the one into materiality) is objective. *Cf. TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976) (noting that the securities laws care only about the “significance of an omitted or misrepresented fact to a reasonable investor"). We therefore must consider when, if ever, the omission of a fact can make a statement of opinion like Omnicare's, even if literally accurate, misleading to an ordinary investor.

Omnicare claims that is just not possible. On its view, no reasonable person, in any context, can understand a pure statement of opinion to convey anything more than the speaker's own mindset. As long as an opinion is sincerely held, Omnicare argues, it cannot mislead as to any matter, regardless what related facts the speaker has omitted. Such statements of belief (concludes Omnicare) are thus immune from liability under § 11's second part, just as they are under its first.

That claim has more than a kernel of truth. A reasonable person understands, and takes into account, the difference we have discussed above between a statement of fact and one of opinion. She recognizes the import of words like "I think" or "I believe," and grasps that they convey some lack of certainty as to the statement's content. See, *e.g.*, Restatement (Second) of Contracts § 168, Comment *a*, p. 456 (1979) (noting that a statement of opinion "implies that [the speaker] . . . is not certain enough of what he says" to do without the qualifying language). And that may be especially so when the phrases appear in a registration statement, which the reasonable investor expects has been carefully wordsmithed to comply with the law. When reading such a document, the investor thus distinguishes between the sentences "we believe X is true" and

"X is true." And because she does so, the omission of a fact that merely rebuts the latter statement fails to render the former misleading. In other words, a statement of opinion is not misleading just because external facts show the opinion to be incorrect. Reasonable investors do not understand such statements as guarantees, and § 11's omissions clause therefore does not treat them that way.

But Omnicare takes its point too far, because a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience. Consider an unadorned statement of opinion about legal compliance: "We believe our conduct is lawful." If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete. In the context of the securities market, an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry—rather than say, on mere intuition, however sincere. Similarly, if the issuer made the statement in the face of its lawyers' contrary advice, or with knowledge that the Federal Government was taking the opposite view, the investor again has cause to complain: He expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer's possession at the time. Thus, if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability.

An opinion statement, however, is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way. Reasonable investors understand that opinions sometimes rest on a weighing of competing facts; indeed, the presence of such facts is one reason why an issuer may frame a statement as an opinion, thus conveying uncertainty. Suppose, for example, that in stating an opinion about legal compliance, the issuer did not disclose that a single junior attorney expressed doubts about a practice's legality, when six of his more senior colleagues gave a stamp of approval. That omission would not make the statement of opinion misleading, even if the minority position ultimately proved correct: A reasonable investor does not expect that *every* fact known to an issuer supports its opinion statement.

Moreover, whether an omission makes an expression of opinion misleading always depends on context. Registration statements as a class are formal documents, filed with the SEC as a legal prerequisite for selling securities to the public. Investors do not, and are right not to, expect opinions contained in those statements to reflect baseless, off-the-cuff judgments, of the kind that an individual might communicate in daily life. At the same time, an investor reads each statement within such a document, whether of fact or of opinion, in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information. And the investor takes into account the customs and practices of the relevant industry. So an omission that renders misleading a statement of opinion when viewed in a vacuum may not do so once that statement is considered, as is appropriate, in a broader frame. The reasonable investor understands a statement of opinion in its full context, and § 11 creates liability only for the omission of material facts that cannot be squared with such a fair reading.

These principles are not unique to § 11: They inhere, too, in much common law respecting the tort of misrepresentation. The Restatement of Torts, for example, recognizes that "[a] statement of opinion as to facts not disclosed and not otherwise known to the recipient may" in some circumstances reasonably "be interpreted by him as an implied statement" that the speaker "knows facts sufficient to justify him in forming" the opinion, or that he at least knows no facts "incompatible with [the] opinion." Restatement (Second) of Torts § 539, p. 85 (1976). When that is so, the Restatement explains, liability may result from omission of facts—for example, the fact that the speaker failed to conduct any investigation—that rebut the recipient's predictable inference. Similarly, the leading treatise in the area explains that "it has been recognized very often that the expression of an opinion may carry with it an implied assertion, not only that the speaker knows no facts which would preclude such an opinion, but that he does know facts which justify it." Prosser and Keeton § 109, at 760. That is especially (and traditionally) the case, the treatise continues, where—as in a registration statement—a speaker "holds himself out or is understood as having special knowledge of the matter which is not available to the plaintiff.". . .

And the purpose of § 11 supports this understanding of how the omissions clause maps onto opinion statements. Congress adopted § 11 to ensure that issuers "tell[ ] the whole truth" to investors. H.R.Rep. No. 85, 73d Cong., 1st Sess., 2 (1933) (quoting President Roosevelt's message to Congress). For that reason, literal accuracy is not enough: An issuer must as well desist from misleading investors by saying one thing and holding back another. Omnicare would nullify that statutory requirement for all sentences starting with the phrases "we believe" or "we think." But those magic words can preface nearly any conclusion, and the resulting statements as we have shown, remain perfectly capable of misleading investors. Thus, Omnicare's view would punch a hole in the statute for half-truths in the form of opinion statements. And the difficulty of showing that such statements are literally false—which requires proving an issuer did not believe them, would make that opening yet more consequential: Were Omnicare right, companies would have virtual *carte blanche* to assert opinions in registration statements free from worry about § 11. That outcome would ill-fit Congress's decision to establish a strict liability offense promoting "full and fair disclosure" of material information.

Omnicare argues, in response, that applying § 11's omissions clause in the way we have described would have "adverse policy consequences." According to Omnicare, any inquiry into the issuer's basis for holding an opinion is "hopelessly amorphous," threatening "unpredictable" and possibly "massive" liability. And because that is so, Omnicare claims, many issuers will choose not to disclose opinions at all, thus "depriving [investors] of potentially helpful information." . . .

But first, that claim is, just as Omnicare labels it, one of "policy"; and Congress gets to make policy, not the courts. The decision Congress made, for the reasons we have indicated, was to extend § 11 liability to all statements rendered misleading by omission. In doing so, Congress no doubt made § 11 less cut-and-dry than a law prohibiting only false factual statements. Section 11's omissions clause, as applied to statements of both opinion and fact, necessarily brings the reasonable person into the analysis, and asks what she would naturally understand a statement to convey beyond its literal meaning. And for expressions of opinion, that means considering the foundation she would expect an issuer to have before making the statement. All that, however, is a feature, not a bug, of the omissions provision.

Moreover, Omnicare way overstates both the looseness of the inquiry Congress has mandated and the breadth of liability that approach threatens. As we have explained, an investor cannot state a claim by alleging only that an opinion was wrong; the complaint must as well call into question the issuer's basis for offering the opinion. And to do so, the investor cannot just say that the issuer failed to reveal its basis. Section 11's omissions clause, after all, is not a general disclosure requirement; it affords a cause of action only when an issuer's failure to include a material fact has rendered a published statement misleading. To press such a claim, an investor must allege that kind of omission—and not merely by means of conclusory assertions. See *Ashcroft v. Iqbal*, 556 U.S. 662, 678, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009) ("Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice"). To be specific: The investor must identify particular (and material) facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context. That is no small task for an investor.

Nor does the inquiry such a complaint triggers ask anything unusual of courts. Numerous legal rules hinge on what a reasonable person would think or expect. In requiring courts to view statements of opinion from an ordinary investor's perspective, § 11's omissions clause demands nothing more complicated or unmanageable. Indeed, courts have for decades engaged in just that inquiry, with no apparent trouble, in applying the common law of misrepresentation.

Finally, we see no reason to think that liability for misleading opinions will chill disclosures useful to investors. Nothing indicates that § 11's application to misleading factual assertions in registration statements has caused such a problem. And likewise, common-law doctrines of opinion liability have not, so far as anyone knows, deterred merchants in ordinary commercial transactions from asserting helpful opinions about their products. That absence of fallout is unsurprising. Sellers (whether of stock or other items) have strong economic incentives to . . . well, *sell* (*i.e.*, hawk or peddle). Those market-based forces push back against any inclination to underdisclose. And to avoid exposure for omissions under § 11, an issuer need only divulge an opinion's basis, or else make clear the real tentativeness of its belief. Such ways of conveying opinions so that they do not mislead will keep valuable information flowing. And that is the only kind of information investors need. To the extent our decision today chills *misleading* opinions, that is all to the good: In enacting § 11, Congress worked to ensure better, not just more, information.

B

Our analysis on this score counsels in favor of sending the case back to the lower courts for decision. Neither court below considered the Funds' omissions theory with the right standard in mind—or indeed, even recognized the distinct statutory questions that theory raises. We therefore follow our ordinary practice of remanding for a determination of whether the Funds have stated a viable omissions claim (or, if not, whether they should have a chance to replead).

In doing so, however, we reemphasize a few crucial points pertinent to the inquiry on remand. Initially, as we have said, the Funds cannot proceed without identifying one or more facts left out of Omnicare's registration statement. The Funds' recitation of the statutory language—that Omnicare "omitted to state facts necessary to make the statements made not misleading"—is not sufficient; neither is the Funds' conclusory allegation that Omnicare lacked "reasonable grounds for the belief" it stated respecting legal compliance. At oral argument, however, the Funds highlighted another, more specific allegation in their complaint: that an attorney had warned Omnicare that a particular contract "carrie[d] a heightened risk" of legal exposure under anti-kickback laws. On remand, the court must review the Funds' complaint to determine whether it adequately alleged that Omnicare had omitted that (purported) fact, or any other like it, from the registration statement. And if so, the court must determine whether the omitted fact would have been material to a reasonable investor—*i.e.*, whether "there is a substantial likelihood that a reasonable [investor] would consider it important." . . .

Assuming the Funds clear those hurdles, the court must ask whether the alleged omission rendered Omnicare's legal compliance opinions misleading in the way described earlier—*i.e.*, because the excluded fact shows that Omnicare lacked the basis for making those statements that a reasonable investor would expect. Insofar as the omitted fact at issue is the attorney's warning, that inquiry entails consideration of such matters as the attorney's status and expertise and other legal information available to Omnicare at the time. Further, the analysis of whether Omnicare's opinion is misleading must address the statement's context. That means the court must take account of whatever facts Omnicare *did* provide about legal compliance, as well as any other hedges, disclaimers, or qualifications it included in its registration statement. The court should consider, for example, the information Omnicare offered that States had initiated enforcement actions against drug manufacturers for giving rebates to pharmacies, that the Federal Government had expressed concerns about the practice, and that the relevant laws "could "be interpreted in the future in a manner" that would harm Omnicare's' business.

With these instructions and for the reasons stated, we vacate the judgment below and remand the case for further proceedings.

It is so ordered.

Justice SCALIA, concurring in part and concurring in the judgment.

Section 11 of the Securities Act of 1933 imposes liability where a registration statement "contain[s] an untrue statement of a material fact" or "omit[s] to state a material fact necessary to make the statements therein not misleading." I agree with the Court's discussion of what it means for an expression of opinion to state an untrue material fact. But an expression of opinion implies facts (beyond the fact that the speaker believes his opinion) only where a reasonable listener would understand it to do so. And it is only when expressions of opinion *do* imply these other facts that they can be "misleading" without the addition of other "material facts." The Court's view would count far more expressions of opinion to convey collateral facts than I—or the common law—would, and I therefore concur only in part.

. . . .

Chapter 8

SECTION 10(b) AND RELATED ISSUES

§ 8.05 Causation and Related Requirements

[E] "Fraud on the Market" Theory

Page 553 add:

HALLIBURTON CO. v. ERICA P. JOHN FUND, INC.

United States Supreme Court

134 S. Ct. 2398 (2014)

Chief Justice Roberts delivered the opinion of the Court.

Investors can recover damages in a private securities fraud action only if they prove that they relied on the defendant's misrepresentation in deciding to buy or sell a company's stock. In *Basic Inc. v. Levinson*, 485 U. S. 224 (1988), we held that investors could satisfy this reliance requirement by invoking a presumption that the price of stock traded in an efficient market reflects all public, material information – including material misstatements. In such a case, we concluded, anyone who buys or sells the stock at the market price may be considered to have relied on those misstatements.

We also held, however, that a defendant could rebut this presumption in a number of ways, including by showing that the alleged misrepresentation did not actually affect the stock's price – that is, that the misrepresentation had no "price impact." The questions presented are whether we should overrule or modify *Basic*'s presumption of reliance and, if not, whether defendants should nonetheless be afforded an opportunity in securities class action cases to rebut the presumption at the class certification stage, by showing a lack of price impact.

I

Respondent Erica P. John Fund, Inc. (EPJ Fund), is the lead plaintiff in a putative class action against Halliburton and one of its executives (collectively Halliburton) alleging violations of section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5. According to EPJ Fund, between June 3, 1999, and December 7, 2001, Halliburton made a series of misrepresentations regarding its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of its merger with another company – all in an attempt to inflate the price of its stock. Halliburton subsequently made a number of corrective disclosures, which, EPJ Fund contends, caused the company's stock price to drop and investors to lose money.

EPJ Fund moved to certify a class comprising all investors who purchased Halliburton common stock during the class period. The District Court found that the proposed class satisfied all the threshold requirements of Federal Rule of Civil Procedure 23(a): It was sufficiently numerous, there were common questions of law or fact, the representative parties' claims were typical of the class claims, and the representatives could fairly and adequately protect the interests of the class. And except for one difficulty, the court would have also concluded that the class satisfied the requirement of Rule 23(b)(3) that "the questions of law or fact common to class members predominate over any questions affecting only individual members." The difficulty was that Circuit precedent required securities fraud plaintiffs to prove "loss causation" – a causal connection between the defendants' alleged misrepresentations and the plaintiffs' economic losses – in order to invoke *Basic*'s presumption of reliance and obtain class certification. Because EPJ Fund had not demonstrated such a connection for any of Halliburton's alleged misrepresentations, the District Court refused to certify the proposed class. The United States Court of Appeals for the Fifth Circuit affirmed the denial of class certification on the same ground. . . .

We granted certiorari and vacated the judgment, finding nothing in "*Basic* or its logic" to justify the Fifth Circuit's requirement that securities fraud plaintiffs prove loss causation at the class certification stage in order to invoke *Basic*'s presumption of reliance. Erica P. John Fund, Inc. v. Halliburton Co., [131 S. Ct. 2179] (2011) (Halliburton I). "Loss causation," we explained, "addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock." We remanded the case for the lower courts to consider "any further arguments against class certification" that Halliburton had preserved.

On remand, Halliburton argued that class certification was inappropriate because the evidence it had earlier introduced to disprove loss causation also showed that none of its alleged misrepresentations had actually affected its stock price. By demonstrating the absence of any "price impact," Halliburton contended, it had rebutted *Basic*'s presumption that the members of the proposed class had relied on its alleged misrepresentations simply by buying or selling its stock at the market price. And without the benefit of the *Basic* presumption, investors would have to prove reliance on an individual basis, meaning that individual issues would predominate over common ones. The District Court declined to consider Halliburton's argument, holding that the *Basic* presumption applied and certifying the class under Rule 23(b)(3).

The Fifth Circuit affirmed. 718 F. 3d 423 (2013). The court found that Halliburton had preserved its price impact argument, but to no avail. While acknowledging that "Halliburton's price impact evidence could be used at the trial on the merits to refute the presumption of reliance," the court held that Halliburton could not use such evidence for that purpose at the class certification stage. . . .

We once again granted certiorari, this time to resolve a conflict among the Circuits over whether securities fraud defendants may attempt to rebut the *Basic* presumption at the class certification stage with evidence of a lack of price impact. We also accepted Halliburton's invitation to reconsider the presumption of reliance for securities fraud claims that we adopted in *Basic*.

II

Halliburton urges us to overrule *Basic*'s presumption of reliance and to instead require every securities fraud plaintiff to prove that he actually relied on the defendant's misrepresentation in deciding to buy or sell a company's stock. Before overturning a long-settled precedent, however, we require "special justification," not just an argument that the precedent was wrongly decided. . . . . Halliburton has failed to make that showing.

A

Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b-5 prohibit making any material misstatement or omission in connection with the purchase or sale of any security. Although section 10(b) does not create an express private cause of action, we have long recognized an implied private cause of action to enforce the provision and its implementing regulation. To recover damages for violations of section 10(b) and Rule 10b-5, a plaintiff must prove "`(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.'" . . . .

The reliance element "`ensures that there is a proper connection between a defendant's misrepresentation and a plaintiff's injury.'". . . "The traditional (and most direct) way a plaintiff can demonstrate reliance is by showing that he was aware of a company's statement and engaged in a relevant transaction – e.g., purchasing common stock – based on that specific misrepresentation."

In *Basic*, however, we recognized that requiring such direct proof of reliance "would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market." That is because, even assuming an investor could prove that he was aware of the misrepresentation, he would still have to "show a speculative state of facts, i.e., how he would have acted . . . if the misrepresentation had not been made.". . .

We also noted that "[r]equiring proof of individualized reliance" from every securities fraud plaintiff "effectively would . . . prevent[ ] [plaintiffs] from proceeding with a class action" in Rule 10b-5 suits. If every plaintiff had to prove direct reliance on the defendant's misrepresentation, “individual issues then would . . . overwhelm[ ] the common ones,” making certification under Rule 23(b)(3) inappropriate.

To address these concerns, *Basic* held that securities fraud plaintiffs can in certain circumstances satisfy the reliance element of a Rule 10b-5 action by invoking a rebuttable presumption of reliance, rather than proving direct reliance on a misrepresentation. The Court based that presumption on what is known as the "fraud-on-the-market" theory, which holds that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." The Court also noted that, rather than scrutinize every piece of public information about a company for himself, the typical "investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price" – the belief that it reflects all public, material information. As a result, whenever the investor buys or sells stock at the market price, his "reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action.". . .

Based on this theory, a plaintiff must make the following showings to demonstrate that the presumption of reliance applies in a given case: (1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed. . . .

At the same time, *Basic* emphasized that the presumption of reliance was rebuttable rather than conclusive. Specifically, "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." So for example, if a defendant could show that the alleged misrepresentation did not, for whatever reason, actually affect the market price, or that a plaintiff would have bought or sold the stock even had he been aware that the stock's price was tainted by fraud, then the presumption of reliance would not apply. In either of those cases, a plaintiff would have to prove that he directly relied on the defendant's misrepresentation in buying or selling the stock.

B

Halliburton contends that securities fraud plaintiffs should always have to prove direct reliance and that the *Basic* Court erred in allowing them to invoke a presumption of reliance instead. According to Halliburton, the *Basic* presumption contravenes congressional intent and has been undermined by subsequent developments in economic theory. Neither argument, however, so discredits *Basic* as to constitute "special justification" for overruling the decision.

1

Halliburton first argues that the *Basic* presumption is inconsistent with Congress's intent in passing the 1934 Exchange Act. Because "[t]he Section 10(b) action is a `judicial construct that Congress did not enact,'" this Court, Halliburton insists, "must identify – and borrow from –the express provision that is `most analogous to the private 10b-5 right of action.'" . . . According to Halliburton, the closest analogue to section 10(b) is section 18(a) of the [Exchange] Act, which creates an express private cause of action allowing investors to recover damages based on misrepresentations made in certain regulatory filings. That provision requires an investor to prove that he bought or sold stock "in reliance upon" the defendant's misrepresentation. In ignoring this direct reliance requirement, the argument goes, the *Basic* Court relieved Rule 10b-5 plaintiffs of a burden that Congress would have imposed had it created the cause of action.

EPJ Fund contests both premises of Halliburton's argument, arguing that Congress has affirmed *Basic*'s construction of section 10(b) and that, in any event, the closest analogue to section 10(b) is not section 18(a) but section 9, 15 U. S. C. §78i – a provision that does not require actual reliance.

We need not settle this dispute. In *Basic*, the dissenting Justices made the same argument based on section 18(a) that Halliburton presses here. . . . The *Basic* majority did not find that argument persuasive then, and Halliburton has given us no new reason to endorse it now.

Halliburton's primary argument for overruling *Basic* is that the decision rested on two premises that can no longer withstand scrutiny. The first premise concerns what is known as the "efficient capital markets hypothesis." *Basic* stated that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." From that statement, Halliburton concludes that the *Basic* Court espoused "a robust view of market efficiency" that is no longer tenable, for "`overwhelming empirical evidence' now `suggests that capital markets are not fundamentally efficient.'". . . To support this contention, Halliburton cites studies purporting to show that "public information is often not incorporated immediately (much less rationally) into market prices.". . .

Halliburton does not, of course, maintain that capital markets are always inefficient. Rather, in its view, *Basic*'s fundamental error was to ignore the fact that "`efficiency is not a binary, yes or no question.'". . . The markets for some securities are more efficient than the markets for others, and even a single market can process different kinds of information more or less efficiently, depending on how widely the information is disseminated and how easily it is understood. Yet *Basic*, Halliburton asserts, glossed over these nuances, assuming a false dichotomy that renders the presumption of reliance both underinclusive and overinclusive: A misrepresentation can distort a stock's market price even in a generally inefficient market, and a misrepresentation can leave a stock's market price unaffected even in a generally efficient one.

Halliburton's criticisms fail to take *Basic* on its own terms. Halliburton focuses on the debate among economists about the degree to which the market price of a company's stock reflects public information about the company – and thus the degree to which an investor can earn an abnormal, above-market return by trading on such information. That debate is not new. Indeed, the *Basic* Court acknowledged it and declined to enter the fray, declaring that "[w]e need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory.". . . To recognize the presumption of reliance, the Court explained, was not "conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price." The Court instead based the presumption on the fairly modest premise that "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices." *Basic*'s presumption of reliance thus does not rest on a "binary" view of market efficiency. Indeed, in making the presumption rebuttable, *Basic* recognized that market efficiency is a matter of degree and accordingly made it a matter of proof.

The academic debates discussed by Halliburton have not refuted the modest premise underlying the presumption of reliance. Even the foremost critics of the efficient-capital markets hypothesis acknowledge that public information generally affects stock prices. . . . Halliburton also conceded as much in its reply brief and at oral argument. . . . Debates about the precise degree to which stock prices accurately reflect public information are thus largely beside the point. "That the . . . price [of a stock] may be inaccurate does not detract from the fact that false statements affect it, and cause loss," which is "all that *Basic* requires." . . . Even though the efficient capital markets hypothesis may have "garnered substantial criticism since *Basic*," Halliburton has not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities. . . ..

Halliburton also contests a second premise underlying the *Basic* presumption: the notion that investors "invest `in reliance on the integrity of [the market] price.'" Halliburton identifies a number of classes of investors for whom "price integrity" is supposedly "marginal or irrelevant." The primary example is the value investor, who believes that certain stocks are undervalued or overvalued and attempts to "beat the market" by buying the undervalued stocks and selling the overvalued ones. . . . If many investors "are indifferent to prices," Halliburton contends, then courts should not presume that investors rely on the integrity of those prices and any misrepresentations incorporated into them.

But *Basic* never denied the existence of such investors. As we recently explained, *Basic* concluded only that "it is reasonable to presume that most investors – knowing that they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information – will rely on the security's market price as an unbiased assessment of the security's value in light of all public information." . . .

In any event, there is no reason to suppose that even Halliburton's main counterexample – the value investor – is as indifferent to the integrity of market prices as Halliburton suggests. Such an investor implicitly relies on the fact that a stock's market price will eventually reflect material information – how else could the market correction on which his profit depends occur? To be sure, the value investor "does not believe that the market price accurately reflects public information *at the time he transacts*." But to indirectly rely on a misstatement in the sense relevant for the *Basic* presumption, he need only trade stock based on the belief that the market price will incorporate public information within a reasonable period. The value investor also presumably tries to estimate *how* undervalued or overvalued a particular stock is, and such estimates can be skewed by a market price tainted by fraud.

C

The principle of *stare decisis* has "`special force'" "in respect to statutory interpretation" because "`Congress remains free to alter what we have done.'" . . . So too with *Basic*'s presumption of reliance. Although the presumption is a judicially created doctrine designed to implement a judicially created cause of action, we have described the presumption as "a substantive doctrine of federal securities-fraud law.". . . That is because it provides a way of satisfying the reliance element of the Rule 10b-5 cause of action. As with any other element of that cause of action, Congress may overturn or modify any aspect of our interpretations of the reliance requirement, including the *Basic* presumption itself. Given that possibility, we see no reason to exempt the *Basic* presumption from ordinary principles of *stare decisis*.

To buttress its case for overruling *Basic*, Halliburton contends that, in addition to being wrongly decided, the decision is inconsistent with our more recent decisions construing the Rule 10b-5 cause of action. As Halliburton notes, we have held that "we must give `narrow dimensions. . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'". . . Yet the *Basic* presumption, Halliburton asserts, does just the opposite, *expanding* the Rule 10b-5 cause of action. . . .

Not so. In *Central Bank and Stoneridge,* we declined to extend Rule 10b-5 liability to entirely new categories of defendants who themselves had not made any material, public misrepresentation. Such an extension, we explained, would have eviscerated the requirement that a plaintiff prove that he relied on a misrepresentation made *by the defendant*. The *Basic* presumption does not eliminate that requirement but rather provides an alternative means of satisfying it. While the presumption makes it easier for plaintiffs to prove reliance, it does not alter the elements of the Rule 10b-5 cause of action and thus maintains the action's original legal scope.

Halliburton also argues that the *Basic* presumption cannot be reconciled with our recent decisions governing class action certification under Federal Rule of Civil Procedure 23. Those decisions have made clear that plaintiffs wishing to proceed through a class action must actually prove – not simply plead – that their proposed class satisfies each requirement of Rule 23, including (if applicable) the predominance requirement of Rule 23(b)(3). According to Halliburton, *Basic* relieves Rule 10b-5 plaintiffs of that burden, allowing courts to presume that common issues of reliance predominate over individual ones.

That is not the effect of the *Basic* presumption. In securities class action cases, the crucial requirement for class certification will usually be the predominance requirement of Rule 23(b)(3). The *Basic* presumption does not relieve plaintiffs of the burden of proving – before class certification – that this requirement is met. *Basic* instead establishes that a plaintiff satisfies that burden by proving the prerequisites for invoking the presumption – namely, publicity, materiality, market efficiency, and market timing. The burden of proving those prerequisites still rests with plaintiffs and (with the exception of materiality) must be satisfied before class certification. *Basic* does not, in other words, allow plaintiffs simply to plead that common questions of reliance predominate over individual ones, but rather sets forth what they must prove to demonstrate such predominance.

Basic does afford defendants an opportunity to rebut the presumption of reliance with respect to an individual plaintiff by showing that he did not rely on the integrity of the market price in trading stock. While this has the effect of "leav[ing] individualized questions of reliance in the case," there is no reason to think that these questions will overwhelm common ones and render class certification inappropriate under Rule 23(b)(3). That the defendant might attempt to pick off the occasional class member here or there through individualized rebuttal does not cause individual questions to predominate.

Finally, Halliburton and its amici contend that, by facilitating securities class actions, the *Basic* presumption produces a number of serious and harmful consequences. Such class actions, they say, allow plaintiffs to extort large settlements from defendants for meritless claims; punish innocent shareholders, who end up having to pay settlements and judgments; impose excessive costs on businesses; and consume a disproportionately large share of judicial resources.

These concerns are more appropriately addressed to Congress, which has in fact responded, to some extent, to many of the issues raised by Halliburton and its *amici*. Congress has, for example, enacted the Private Securities Litigation Reform Act of 1995 (PSLRA), 109 Stat. 737, which sought to combat perceived abuses in securities litigation with heightened pleading requirements, limits on damages and attorney's fees, a "safe harbor" for certain kinds of statements, restrictions on the selection of lead plaintiffs in securities class actions, sanctions for frivolous litigation, and stays of discovery pending motions to dismiss. And to prevent plaintiffs from circumventing these restrictions by bringing securities class actions under state law in state court, Congress also enacted the Securities Litigation Uniform Standards Act of 1998, 112 Stat. 3227, which precludes many state law class actions alleging securities fraud. Such legislation demonstrates Congress's willingness to consider policy concerns of the sort that Halliburton says should lead us to overrule *Basic*.

III

Halliburton proposes two alternatives to overruling *Basic* that would alleviate what it regards as the decision's most serious flaws. The first alternative would require plaintiffs to prove that a defendant's misrepresentation actually affected the stock price – so-called "price impact" – in order to invoke the *Basic* presumption. It should not be enough, Halliburton contends, for plaintiffs to demonstrate the general efficiency of the market in which the stock traded. Halliburton's second proposed alternative would allow *defendants* to rebut the presumption of reliance with evidence of a lack of price impact, not only at the merits stage – which all agree defendants may already do – but also before class certification. [emphasis supplied]

A

As noted, to invoke the *Basic* presumption, a plaintiff must prove that: (1) the alleged misrepresentations were publicly known, (2) they were material, (3) the stock traded in an efficient market, and (4) the plaintiff traded the stock between when the misrepresentations were made and when the truth was revealed. . . . Each of these requirements follows from the fraud-on-the-market theory underlying the presumption. If the misrepresentation was not publicly known, then it could not have distorted the stock's market price. So too if the misrepresentation was immaterial – that is, if it would not have "`been viewed by the reasonable investor as having significantly altered the "total mix" of information made available,'" . . . – or if the market in which the stock traded was inefficient. And if the plaintiff did not buy or sell the stock after the misrepresentation was made but before the truth was revealed, then he could not be said to have acted in reliance on a fraud-tainted price.

The first three prerequisites are directed at price impact – "whether the alleged misrepresentations affected the market price in the first place." In the absence of price impact, *Basic*'s fraud-on-the-market theory and presumption of reliance collapse. The "fundamental premise" underlying the presumption is "that an investor presumptively relies on a misrepresentation so long as it was reflected in the market price at the time of his transaction." If it was not, then there is "no grounding for any contention that [the] investor[ ] indirectly relied on th[at] misrepresentation[ ] through [his] reliance on the integrity of the market price." . . .

Halliburton argues that since the *Basic* presumption hinges on price impact, plaintiffs should be required to prove it directly in order to invoke the presumption. Proving the presumption's prerequisites, which are at best an imperfect proxy for price impact, should not suffice.

Far from a modest refinement of the *Basic* presumption, this proposal would radically alter the required showing for the reliance element of the Rule 10b-5 cause of action. What is called the *Basic* presumption actually incorporates two constituent presumptions: First, if a plaintiff shows that the defendant's misrepresentation was public and material and that the stock traded in a generally efficient market, he is entitled to a presumption that the misrepresentation affected the stock price. Second, if the plaintiff also shows that he purchased the stock at the market price during the relevant period, he is entitled to a further presumption that he purchased the stock in reliance on the defendant's misrepresentation.

By requiring plaintiffs to prove price impact directly, Halliburton's proposal would take away the first constituent presumption. Halliburton's argument for doing so is the same as its primary argument for overruling the *Basic* presumption altogether: Because market efficiency is not a yes-or-no proposition, a public, material misrepresentation might not affect a stock's price even in a generally efficient market. But as explained, *Basic* never suggested otherwise; that is why it affords defendants an opportunity to rebut the presumption by showing, among other things, that the particular misrepresentation at issue did not affect the stock's market price. For the same reasons we declined to completely jettison the *Basic* presumption, we decline to effectively jettison half of it by revising the prerequisites for invoking it.

B

Even if plaintiffs need not directly prove price impact to invoke the *Basic* presumption, Halliburton contends that defendants should at least be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price. We agree.

There is no dispute that defendants may introduce such evidence at the merits stage to rebut the *Basic* presumption. *Basic* itself "made clear that the presumption was just that, and could be rebutted by appropriate evidence," including evidence that the asserted misrepresentation (or its correction) did not affect the market price of the defendant's stock. . . .

Nor is there any dispute that defendants may introduce price impact evidence at the class certification stage, so long as it is for the purpose of countering a plaintiff's showing of market efficiency, rather than directly rebutting the presumption. As EPJ Fund acknowledges, "[o]f course . . . defendants can introduce evidence at class certification of lack of price impact as some evidence that the market is not efficient." . . .

After all, plaintiffs themselves can and do introduce evidence of the *existence* of price impact in connection with "event studies" – regression analyses that seek to show that the market price of the defendant's stock tends to respond to pertinent publicly reported events. . . . In this case, for example, EPJ Fund submitted an event study of various episodes that might have been expected to affect the price of Halliburton's stock, in order to demonstrate that the market for that stock takes account of material, public information about the company. The episodes examined by EPJ Fund's event study included one of the alleged misrepresentations that form the basis of the Fund's suit. . . .

Defendants – like plaintiffs – may accordingly submit price impact evidence prior to class certification. What defendants may not do, EPJ Fund insists and the Court of Appeals held, is rely on that same evidence prior to class certification for the particular purpose of rebutting the presumption altogether.

This restriction makes no sense, and can readily lead to bizarre results. Suppose a defendant at the certification stage submits an event study looking at the impact on the price of its stock from six discrete events, in an effort to refute the plaintiffs' claim of general market efficiency. All agree the defendant may do this. Suppose one of the six events is the specific misrepresentation asserted by the plaintiffs. All agree that this too is perfectly acceptable. Now suppose the district court determines that, despite the defendant's study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit. The evidence at the certification stage thus shows an efficient market, on which the alleged misrepresentation had no price impact. And yet under EPJ Fund's view, the plaintiffs' action should be certified and proceed as a class action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed.

Such a result is inconsistent with *Basic*'s own logic. Under *Basic*'s fraud-on-the-market theory, market efficiency and the other prerequisites for invoking the presumption constitute an indirect way of showing price impact. As explained, it is appropriate to allow plaintiffs to rely on this indirect proxy for price impact, rather than requiring them to prove price impact directly, given *Basic*'s rationales for recognizing a presumption of reliance in the first place.

But an indirect proxy should not preclude direct evidence when such evidence is available. As we explained in *Basic*, "[a]ny showing that severs the link between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff . . . will be sufficient to rebut the presumption of reliance" because "the basis for finding that the fraud had been transmitted through market price would be gone." And without the presumption of reliance, a Rule 10b-5 suit cannot proceed as a class action: Each plaintiff would have to prove reliance individually, so common issues would not "predominate" over individual ones, as required by Rule 23(b)(3). Price impact is thus an essential precondition for any Rule 10b-5 class action. While *Basic* allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply.

The Court of Appeals relied on our decision in *Amgen* in holding that Halliburton could not introduce evidence of lack of price impact at the class certification stage. The question in *Amgen* was whether plaintiffs could be required to prove (or defendants be permitted to disprove) materiality before class certification. Even though materiality is a prerequisite for invoking the *Basic* presumption, we held that it should be left to the merits stage, because it does not bear on the predominance requirement of Rule 23(b)(3). We reasoned that materiality is an objective issue susceptible to common, classwide proof. We also noted that a failure to prove materiality would necessarily defeat every plaintiff 's claim on the merits; it would not simply preclude invocation of the presumption and thereby cause individual questions of reliance to predominate over common ones. In this latter respect, we explained, materiality differs from the publicity and market efficiency prerequisites, neither of which is necessary to prove a Rule 10b-5 claim on the merits.

EPJ Fund argues that much of the foregoing could be said of price impact as well. Fair enough. But price impact differs from materiality in a crucial respect. Given that the other *Basic* prerequisites must still be proved at the class certification stage, the common issue of materiality can be left to the merits stage without risking the certification of classes in which individual issues will end up overwhelming common ones. And because materiality is a discrete issue that can be resolved in isolation from the other prerequisites, it can be wholly confined to the merits stage.

Price impact is different. The fact that a misrepresentation "was reflected in the market price at the time of [the] transaction" – that it had price impact – is "*Basic*'s fundamental premise.". . . It thus has everything to do with the issue of predominance at the class certification stage. That is why, if reliance is to be shown through the *Basic* presumption, the publicity and market efficiency prerequisites must be proved before class certification. Without proof of those prerequisites, the fraud-on-the-market theory underlying the presumption completely collapses, rendering class certification inappropriate.

But as explained, publicity and market efficiency are nothing more than prerequisites for an indirect showing of price impact. There is no dispute that at least such indirect proof of price impact "is needed to ensure that the questions of law or fact common to the class will `predominate.'" . . . That is so even though such proof is also highly relevant at the merits stage.

Our choice in this case, then, is not between allowing price impact evidence at the class certification stage or relegating it to the merits. Evidence of price impact will be before the court at the certification stage in any event. The choice, rather, is between limiting the price impact inquiry before class certification to indirect evidence, or allowing consideration of direct evidence as well. As explained, we see no reason to artificially limit the inquiry at the certification stage to indirect evidence of price impact. Defendants may seek to defeat the *Basic* presumption at that stage through direct as well as indirect price impact evidence.

* * *

More than 25 years ago, we held that plaintiffs could satisfy the reliance element of the Rule 10b-5 cause of action by invoking a presumption that a public, material misrepresentation will distort the price of stock traded in an efficient market, and that anyone who purchases the stock at the market price may be considered to have done so in reliance on the misrepresentation. We adhere to that decision and decline to modify the prerequisites for invoking the presumption of reliance. But to maintain the consistency of the presumption with the class certification requirements of Federal Rule of Civil Procedure 23, defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.

Because the courts below denied Halliburton that opportunity, we vacate the judgment of the Court of Appeals for the Fifth Circuit and remand the case for further proceedings consistent with this opinion.

It is so ordered.

Justice Ginsburg, with whom Justice Breyer and Justice Sotomayor join, concurring.

Advancing price impact consideration from the merits stage to the certification stage may broaden the scope of discovery available at certification. But the Court recognizes that it is incumbent upon the defendant to show the absence of price impact. The Court's judgment, therefore, should impose no heavy toll on securities-fraud plaintiffs with tenable claims. On that understanding, I join the Court's opinion.

Justice Thomas, with whom Justice Scalia and Justice Alito join, concurring in the judgment.

The implied Rule 10b-5 private cause of action is "a relic of the heady days in which this Court assumed common-law powers to create causes of action." . . . We have since ended that practice because the authority to fashion private remedies to enforce federal law belongs to Congress alone. . . . Absent statutory authorization for a cause of action, "courts may not create one, no matter how desirable that might be as a policy matter."

Basic Inc. v. Levinson, 485 U. S. 224 (1988), demonstrates the wisdom of this rule. *Basic* presented the question how investors must prove the reliance element of the implied Rule 10b-5 cause of action – the requirement that the plaintiff buy or sell stock in reliance on the defendant's misstatement – when they transact on modern, impersonal securities exchanges. Were the Rule 10b-5 action statutory, the Court could have resolved this question by interpreting the statutory language. Without a statute to interpret for guidance, however, the Court began instead with a particular policy "problem": for investors in impersonal markets, the traditional reliance requirement was hard to prove and impossible to prove as common among plaintiffs bringing 10b-5 class-action suits. With the task thus framed as "resol[ving]" that "`problem'" rather than interpreting statutory text, the Court turned to nascent economic theory and naked intuitions about investment behavior in its efforts to fashion a new, easier way to meet the reliance requirement. The result was an evidentiary presumption, based on a "fraud on the market" theory, that paved the way for class actions under Rule 10b-5.

Today we are asked to determine whether *Basic* was correctly decided. The Court suggests that it was, and that *stare decisis* demands that we preserve it. I disagree. Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains. *Basic* should be overruled.

. . . .

* * *

. . . *Basic* should be overruled in favor of the straightforward rule that "[r]eliance by the plaintiff upon the defendant's deceptive acts" – actual reliance, not the fictional "fraud-on-the-market" version – "is an essential element of the §10(b) private cause of action."

* * *

. . . . *Basic* took an implied cause of action and grafted on a policy-driven presumption of reliance based on nascent economic theory and personal intuitions about investment behavior. The result was an unrecognizably broad cause of action ready made for class certification. Time and experience have pointed up the error of that decision, making it all too clear that the Court's attempt to revise securities law to fit the alleged "new realities of financial markets" should have been left to Congress.

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§ 8.13 EXTRATERRITORIAL REACH OF SECTION 10(b)

page 622 add:

CITY OF PONTIAC POLICEMEN’S AND FIREMEN’S RETIREMENT SYSTEM v. UBS A G

United States Court of Appeals

2014 U.S. App. LEXIS 8533 (2d Cir. 2014)

José A. Cabranes, Circuit Judge:

In this appeal we consider, as a matter of first impression, whether the bar on extraterritorial application of the United States securities laws, as set forth in *Morrison v. National Australia Bank Ltd.,* 561 U.S. 247 (2010), precludes claims arising out of foreign-issued securities purchased on foreign exchanges, but cross-listed on a domestic exchange (the so-called "listing theory"). . . .

We conclude that . . . the Supreme Court's decision in *Morrison* precludes claims brought pursuant to the Securities Exchange Act of 1934 ("Exchange Act") by purchasers of shares of a foreign issuer on a foreign exchange, even if those shares were cross-listed on a United States exchange. . . .

Plaintiffs, a group of foreign and domestic institutional investors, bring this putative class action against UBS AG ("UBS") and a number of UBS officers and directors (together with UBS, "UBS Defendants"), alleging violations of §§ 10(b) and 20(a) of the Exchange Act in connection with the purchase of UBS "ordinary shares" between August 13, 2003 and February 23, 2009 (the "Class Period"). These shares were listed on foreign exchanges and the New York Stock Exchange ("NYSE"). . . .

. . . .

Viability Under Morrison v. National Australia Bank of Claims Based on Foreign Shares Purchased on a Foreign Exchange

Three foreign institutional investors – plaintiffs Union, IFM, and ATP – and one domestic investor – plaintiff OPEB – purchased their UBS (foreign-issued) ordinary shares on a foreign exchange. The District Court, relying on the Supreme Court's decision in *Morrison v. National Australia Bank,* dismissed these claims. We address the claims of the foreign and domestic plaintiffs separately.

1. "Foreign Cubed" Claims[1]

Morrison answered in the negative the question "whether [§ 10(b)] provides a cause of action to foreign plaintiffs suing foreign defendants for misconduct in connection with securities traded on foreign exchanges." It held instead that § 10(b) only provided a private cause of action arising out of "[1] transactions in securities listed on domestic exchanges, and [2] domestic transactions in other securities."

Plaintiffs argue that, by its express terms, the *Morrison* bar is limited to claims arising out of securities "*[not] listed* on a domestic exchange." Under plaintiffs' so-called "listing theory," the fact that the relevant shares were cross-

[1] A so-called "foreign-cubed" action involves claims in which "foreign plaintiffs [are] suing (2) a foreign issuer in an American court for violations of American securities laws based on securities transactions in [3] foreign countries.". . .

listed on the NYSE brings them within the purview of Rule 10(b), under the first prong of *Morrison* – "transactions in securities listed on domestic exchanges." We conclude that, while this language, which appears in *Morrison* and its progeny, taken in isolation, supports plaintiffs' view, the "listing theory" is irreconcilable with *Morrison* read as a whole.

Morrison emphasized that "the focus of the Exchange Act is . . . upon *purchases and sales* of securities in the United States." As the District Court recognized, this evinces a concern with "the location of the securities *transaction* and not the location of an exchange where the security may be dually listed." *Morrison's* emphasis on "*transactions* in securities listed on domestic exchanges," makes clear that the focus of both prongs was domestic transactions of any kind, with the domestic listing acting as a proxy for a domestic transaction. Indeed, the Supreme Court explicitly rejected the notion that the "*national* public interest pertains to transactions conducted upon *foreign* exchanges and markets." Furthermore, in *Morrison,* although the Ordinary Shares at issue were not traded on any domestic exchange, the Court noted that "[t]here are listed on the [NYSE], however, [defendant]'s American Depositary Receipts (ADRs), which represent the right to receive a specified number of [its] Ordinary Shares." This did not affect the Court's analysis of the shares that were purchased on foreign exchanges.

Perhaps most tellingly, in rejecting this Circuit's "conduct and effects" test in favor of a bright-line rule, *Morrison* rejected our prior holding that "`the Exchange Act [applies] to transactions regarding stocks traded in the United States which are effected outside the United States . . . .'"

In sum, *Morrison* does not support the application of § 10(b) of the Exchange Act to claims by a foreign purchaser of foreign-issued shares on a foreign exchange simply because those shares are also listed on a domestic exchange. Accordingly, we affirm the judgment of the District Court insofar as it dismissed the claims of Union, IFM, and ATP.

2. "Foreign Squared" Claims

Plaintiff OPEB is a U.S. entity that purchased some of its UBS shares on a foreign exchange by placing a so-called "buy order" in the United States, which was later executed on a Swiss exchange. In addition to advocating the "listing theory," OPEB argues that its purchase satisfies the second prong of *Morrison* because it constitutes a "purchase . . . of [a] security in the United States."

In our decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto* ("*Absolute Activist*"), we explained that "[a] securities transaction is domestic [for purposes of *Morrison's* second prong] when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States.'" We must now decide – as an issue of first impression –

whether the mere placement of a buy order in the United States for the purchase of foreign securities on a foreign exchange is sufficient to allege that a purchaser incurred irrevocable liability in the United States, such that the U.S. securities laws govern the purchase of those securities. We conclude that it is not.

Plaintiffs argue that "[w]hen a purchaser is a U.S. entity, 'irrevocable liability' is not incurred when the security is purchased on a foreign exchange [; rather it is incurred] in the U.S. where the buy order is placed." As an initial matter, we have made clear that "a purchaser's citizenship or residency does not affect where a transaction occurs." Accordingly, the fact that OPEB was a U.S. entity, does not affect whether the transaction was foreign or domestic. Nor does the allegation that OPEB placed a buy order in the United States that was then executed on a foreign exchange, standing alone, establish that OPEB incurred irrevocable liability in the United States.

Accordingly, we affirm the judgment of the District Court dismissing the claims of OPEB, a domestic purchaser, insofar as its claims were based on purchases of foreign shares on foreign exchanges.

. . . .

Chapter 9

ALTERNATIVE PROVISIONS

§ 9.08 STATE SECURITIES AND COMMON LAW REMEDIES

page 682 add:

CHADBOURNE & PARKE LLP

v.

TROICE

United States Supreme Court

___ U.S. ___, 134 S. Ct. 1058, 188 L. Ed. 2d 88 (2014)

JUSTICE BREYER delivered the opinion of the Court.

The Securities Litigation Uniform Standards Act of 1998 (which we shall refer to as the "Litigation Act") forbids the bringing of large securities class actions based upon violations of state law. It says that plaintiffs may not maintain a class action "based upon the statutory or common law of any State" in which the plaintiffs allege "a misrepresentation or omission of a material fact *in connection with the purchase or sale of a covered security*." 15 U. S. C. §78bb(f)(1) (emphasis added). The Act defines "class actions" as those involving more than 50 members. It defines "covered security" narrowly to include only securities traded on a national exchange (or, here irrelevant, those issued by investment companies).

The question before us is whether the Litigation Act encompasses a class action in which the plaintiffs allege (1) that they "purchase[d]" *uncovered* securities (certificates of deposit that are *not* traded on any national exchange), but (2) that the defendants falsely told the victims that the *uncovered* securities were backed by *covered* securities. We note that the plaintiffs do not allege that the defendants' misrepresentations led anyone to buy or to sell (or to maintain positions in) *covered* securities. Under these circumstances, we conclude the Act does not apply.

In light of the dissent's characterization of our holding – which we believe is incorrect – we specify at the outset that this holding does *not* limit the Federal Government's authority to prosecute "frauds like the one here." The Federal Government *has* in fact brought successful prosecutions against the fraudsters at the heart of this litigation, and we fail to understand the dissent's repeated suggestions to the contrary. . . . Rather, as we shall explain, we believe the basic consequence of our holding is that, without limiting the Federal Government's prosecution power in any significant way, it will permit victims of this (and similar) frauds to recover damages under state law. Under the dissent's approach, they would have no such ability.

I

A

The relevant statutory framework has four parts:

(1) Section 10(b) of the underlying regulatory statute, *the Securities Exchange Act of 1934.* This well-known statutory provision forbids the "use" or "employ[ment]" of "any manipulative or deceptive device or contrivance" "in connection with the purchase or sale of any security."

Securities and Exchange Commission Rule 10b-5 similarly forbids the use of any "device, scheme, or artifice to defraud" (including the making of "any untrue statement of a material fact" or any similar "omi[ssion]") "in connection with the purchase or sale of any security."

For purposes of these provisions, the Securities Exchange Act defines "security" *broadly* to include not just things traded on national exchanges, but also "any note, stock, treasury stock, security future, security-based swap, bond, debenture . . . [or] certificate of deposit for a security." 15 U. S. C. §78c(a)(10). See also §§77b(a)(1), 80a-2(a) (36), 80b-2(a)(18) (providing virtually identical definitions of "security" for the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940).

(2) A statute-based private right of action. The Court has read §10(b) and Rule 10b-5 as providing injured persons with a private right of action to sue for

damages suffered through those provisions' violation. See, *e.g.*, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 730 (1975).

The scope of the private right of action is more limited than the scope of the statutes upon which it is based. See *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*, 552 U. S. 148 (2008) (private right does not cover suits against "secondary actors" who had no "role in preparing or disseminating" a stock issuer's fraudulent "financial statements"); *Central Bank of Denver, N. A.* v. *First Interstate Bank of Denver, N. A.*, 511 U. S. 164, 179 (1994) (private right does not extend to actions against "aiders and abettors" of securities fraud); *Blue Chip Stamps*, *supra*, at 737 (private right extends only to purchasers and sellers, not to holders, of securities).

(3) The Private Securities Litigation Reform Act of 1995 (PSLRA). 109 Stat. 737, 15 U. S. C. §§77z-1, 78u-4. This law imposes procedural and substantive limitations upon the scope of the private right of action available under §10(b) and Rule 10b-5. It requires plaintiffs to meet heightened pleading standards. It permits defendants to obtain automatic stays of discovery. It limits recoverable damages and attorney's fees. And it creates a new "safe harbor" for forward-looking statements.

(4) The Securities Litigation Uniform Standards Act. 112 Stat. 3227, 15 U. S. C. §78bb(f)(1)(A). As we said at the outset, this 1998 law forbids any

> "covered class action based upon the statutory or common law of any State . . . by any private party alleging –
>
> "(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> "(B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security."

The law defines "covered security" narrowly. It is a security that "satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933." §78bb(f)(5)(E). And the relevant paragraphs of §18(b) of the 1933 Act define a "covered security" as "[a security] listed, or authorized for listing, on a national securities exchange" . . . . The Litigation Act also specifies that a "covered security" must be listed or authorized for listing on a national exchange "at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred."

The Litigation Act sets forth exceptions. It does not apply to class actions with fewer than 51 "persons or prospective class members." It does not apply to actions brought on behalf of a State itself. It does not apply to class actions based on the law "of the State in which the issuer is incorporated." And it reserves the authority of state securities commissions "to investigate and bring enforcement actions."

We are here primarily interested in the Litigation Act's phrase "misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." Unless this phrase applies to the class actions before us, the plaintiffs may maintain their state-law-based class actions, and they may do so either in federal or state court. Otherwise, their class actions are precluded altogether. See §78bb(f)(2) (providing for the removal from state to federal court of class actions that meet the specifications of paragraph 1, and for the dismissal of such suits by the district court).

B

1

The plaintiffs in these actions (respondents here) say that Allen Stanford and several of his companies ran a multibillion dollar Ponzi scheme. Essentially, Stanford and his companies sold the plaintiffs certificates of deposit in Stanford International Bank. Those certificates "were debt assets that promised a fixed rate of return." *Roland* v. *Green*, 675 F. 3d 503, 522 (CA5 2012). The plaintiffs expected that Stanford International Bank would use the money it received to buy highly lucrative assets. But instead, Stanford and his associates used the money provided by new investors to repay old investors, to finance an elaborate lifestyle, and to finance speculative real estate ventures.

The Department of Justice brought related criminal charges against Allen Stanford. A jury convicted Stanford of mail fraud, wire fraud, conspiracy to commit money laundering, and obstruction of a Securities and Exchange Commission investigation. Stanford was sentenced to prison and required to forfeit $6 billion. The SEC, noting that the Bank certificates of deposit fell within the 1934 Securities Exchange Act's broad definition of "security," filed a §10(b) civil case against Allen Stanford, the Stanford International Bank, and related Stanford companies and associates. The SEC won the civil action, and the court imposed a civil penalty of $6 billion.

2

The plaintiffs in each of the four civil class actions are private investors who bought the Bank's certificates of deposit. Two groups of plaintiffs filed their actions in Louisiana state court against firms and individuals who helped sell the Bank's certificates by working as "investment advisers" affiliated with Stanford, or who provided Stanford-related companies with trust, insurance, accounting, or reporting services. (The defendants included a respondent here, SEI Investments Company.) The plaintiffs claimed that the defendants helped the Bank perpetrate the fraud, thereby violating Louisiana state law.

Two other groups of plaintiffs filed their actions in federal court for the Northern District of Texas. One group sued Willis of Colorado (and related Willis companies) and Bowen, Miclette & Britt, two insurance brokers; the other group sued Proskauer Rose and Chadbourne & Parke, two law firms. Both groups claimed that the defendants helped the Bank (and Allen Stanford) perpetrate the fraud or conceal it from regulators, thereby violating Texas securities law.

The Louisiana state-court defendants removed their cases to federal court, and the Judicial Panel on Multi-District Litigation moved the Louisiana cases to the Northern District of Texas. A single federal judge heard all four class actions.

The defendants in each of the cases moved to dismiss the complaints. The District Court concluded that the Litigation Act required dismissal. The court recognized that the certificates of deposit themselves were not "covered securities" under the Litigation Act, for they were not "`traded nationally [or] listed on a regulated national exchange.'" But each complaint in one way or another alleged that the fraud included misrepresentations that the Bank maintained significant holdings in "`highly marketable securities issued by stable governments [and] strong multinational companies,'" and that the Bank's ownership of these "covered" securities made investments in the uncovered certificates more secure. The court concluded that this circumstance provided the requisite statutory "connection" between (1) the plaintiffs' state-law fraud claims, and (2) "transactions in covered securities." Hence, the court dismissed the class actions under the Litigation Act.

All four sets of plaintiffs appealed. The Fifth Circuit reversed. It agreed with the District Court that the complaints described misrepresentations about the Bank's investments in nationally traded securities. Still, the "heart, crux, and gravamen of" the "allegedly fraudulent scheme was representing . . . that the [uncovered] CDs were a `safe and secure' investment that was preferable to other investments for many reasons." The court held that the falsehoods about the Bank's holdings in covered securities were too "`tangentially related'" to the "crux" of the fraud to trigger the Litigation Act. "That the CDs were marketed with some vague references to [the Bank's] portfolio containing instruments that might be [covered by the Litigation Act] seems tangential to the schemes," to the point where the complaints fall outside the scope of that Act. 675 F. 3d, at 522.

Defendants in the four class actions sought certiorari. We granted their petitions.

II

The question before us concerns the scope of the Litigation Act's phrase "misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." §78bb(f)(1)(A). How broad is that scope? Does it extend further than misrepresentations that are material to the purchase or sale of a covered security?

In our view, the scope of this language does not extend further. To put the matter more specifically: A fraudulent misrepresentation or omission is not made "in connection with" such a "purchase or sale of a covered security" unless it is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a *"covered security."* [emphasis supplied] We add that in *Merrill Lynch, Pierce, Fenner & Smith Inc.* v. *Dabit*, 547 U. S. 71 (2006), we held that the Litigation Act precluded a suit where the plaintiffs alleged a "fraudulent manipulation of stock prices" that was material to and "`concide[d]' with" third-party securities transactions, while also inducing the plaintiffs to "hold their stocks long beyond the point when, had the truth been known, they would have sold." We do not here modify *Dabit.*

A

We reach this interpretation of the Litigation Act for several reasons. First, the Act focuses upon transactions in covered securities, not upon transactions in uncovered securities. An interpretation that insists upon a material connection with a transaction in a covered security is consistent with the Act's basic focus.

Second, a natural reading of the Act's language supports our interpretation. The language requires the dismissal of a state-law-based class action where a private party alleges a "misrepresentation or omission of a material fact" (or engages in other forms of deception, not relevant here) "in connection with the purchase or sale of a covered security." §78bb(f)(1). The phrase "material fact in connection with the purchase or sale" suggests a connection that matters. And for present purposes, a connection matters where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security, not to purchase or to sell an uncovered security, something about which the Act expresses no concern. Further, the "someone" making that decision to purchase or sell must be a party other than the fraudster. If the only party who decides to buy or sell a covered security as a result of a lie is the liar, that is not a "connection" that matters.

Third, prior case law supports our interpretation. As far as we are aware, every securities case in which this Court has found a fraud to be "in connection with" a purchase or sale of a security has involved victims who took, who tried to take, who divested themselves of, who tried to divest themselves of, or who maintained *an ownership interest* in financial instruments that fall within the relevant statutory definition. . . . We have found no Court case involving a fraud "in connection with" the purchase or sale of a statutorily defined security in which the victims did not fit one of these descriptions. And the dissent apparently has not either.

Although the dissent characterizes our approach as "new," and tries to describe several of our prior cases in a different way, it cannot escape the fact that every case it cites involved a victim who took, tried to take, or maintained an ownership position in the statutorily relevant securities through "purchases" or "sales" induced by the fraud. . . .

Fourth, we read the Litigation Act in light of and consistent with the underlying regulatory statutes, the Securities Exchange Act of 1934 and the Securities Act of 1933. The regulatory statutes refer to persons engaged in securities transactions that lead to the taking or dissolving of ownership positions. And they make it illegal to deceive a person when he or she is doing so. Section 5 of the 1933 Act, for example, makes it unlawful to "offer to sell or offer to buy . . . any security, unless a registration statement has been filed as to such security." Section 17 of the 1933 Act makes it unlawful "in the offer or sale of any securities . . . to employ any device, scheme, or artifice to defraud, or to obtain money or property by means of any untrue statement of a material fact." And §10(b) of the 1934 Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance."

Not only language but also purpose suggests a statutory focus upon transactions involving the statutorily relevant securities. The basic purpose of the 1934 and 1933 regulatory statutes is "to insure honest securities markets and thereby promote investor confidence." Nothing in the regulatory statutes suggests their object is to protect persons whose connection with the statutorily defined securities is more remote than words such as "buy," "sell," and the like, indicate. Nor does anything in the Litigation Act provide us with reasons for interpreting its similar language more broadly.

The dissent correctly points out that the federal securities laws have another purpose, beyond protecting investors. Namely, they also seek to protect securities *issuers,* as well as the investment advisers, accountants, and brokers who help them sell financial products, from abusive class-action lawsuits. Both the PSLRA and the Litigation Act were enacted in service of that goal. By imposing heightened pleading standards, limiting damages, and pre-empting state-law suits where the claims pertained to covered securities, Congress sought to reduce frivolous suits and mitigate legal costs for firms and investment professionals that participate in the market for nationally traded securities.

We fail to see, however, how our decision today undermines that objective. The dissent worries our approach will "subject many persons and entities whose profession it is to give advice, counsel, and assistance in investing in the securities markets to complex and costly state-law litigation." To the contrary, the *only* issuers, investment advisers, or accountants that today's decision will continue to subject to state-law liability are those who do not sell or participate in selling securities traded on U. S. national exchanges. We concede that this means a bank, chartered in Antigua and whose sole product is a fixed-rate debt instrument not traded on a U. S. exchange, will not be able to claim the benefit of preclusion under the Litigation Act. But it is difficult to see why the federal securities laws would be – or should be – concerned with shielding such entities from lawsuits.

Fifth, to interpret the necessary statutory "connection" more broadly than we do here would interfere with state efforts to provide remedies for victims of ordinary state law frauds. A broader interpretation would allow the Litigation Act to cover, and thereby to prohibit, a lawsuit brought by creditors of a small business that falsely represented it was creditworthy, in part because it owns or intends to own exchange-traded stock. It could prohibit a lawsuit brought by homeowners against a mortgage broker for lying about the interest rates on their mortgages – if, say, the broker (not the homeowners) later sold the mortgages to a bank which then securitized them in a pool and sold off pieces as "covered securities."

The dissent all but admits this. Its proposed rule is that whenever "the purchase or sale of the securities [including by the fraudster] is what enables the fraud," the Litigation Act pre-empts the suit. In other words, *any time* one person convinces another to loan him money, by pretending he owns nationally traded securities or will acquire them for himself in the future, the action constitutes federal securities fraud, is subject to federal enforcement, and is *also* precluded by the Litigation Act if it qualifies as a "covered class action" under §78bb(f)(5)(B) (*e.g.,* involves more than 50 members). Leaving aside whether this would work a significant expansion of the scope of liability under the federal securities laws, it unquestionably would limit the scope of protection under state laws that seek to provide remedies to victims of garden-variety fraud.

The text of the Litigation Act reflects congressional care to avoid such results. Under numerous provisions, it purposefully maintains state legal authority, especially over matters that are primarily of state concern. See §§78bb(f)(1)(A)-(B) (limiting preclusion to lawsuits involving "covered," *i.e.,* nationally traded, securities); §78bb(f)(4) (providing that the "securities commission . . . of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions"); §78bb(f)(3)(B) (preserving States' authority to bring suits of the kind forbidden to private class-action plaintiffs). . . . A broad interpretation of the Litigation Act works at cross-purposes with this state-oriented concern. Cf. *Zandford,* 535 U. S., at 820 (warning against "constru[ing]" the phrase "in connection with" "so broadly as to convert any common-law fraud that happens to involve securities into a violation of §10(b)"); *Wharf (Holdings) Ltd.,* 532 U. S., at 596 (recognizing that "ordinary state breach-of-contract claims" are "actions that lie outside the [Securities Exchange] Act's basic objectives").

B

Respondents and the Government make two important counterarguments. Respondents point to statements we have made suggesting we should give the phrase "in connection with" a broad interpretation. In *Dabit,* for example, we said that the Court has consistently "espoused a broad interpretation" of "in connection with" in the context of §10(b) and Rule 10b-5, and we added that the Litigation Act language similarly warranted a "broad construction." In *Bankers Life,* we said that, if a deceptive practice "touch[es]" a securities transaction, it meets §10(b)'s "in connection with" requirement, 404 U. S., at 12, and in *O'Hagan,* we said the fraud and the purchase or sale of a security must simply "coincide." 521 U. S., at 656. The idea, we explained in *Zandford,* is that the phrase "should be `construed not technically and restrictively, but flexibly to effectuate its remedial purposes.'" . . . .

Every one of these cases, however, concerned a false statement (or the like) that was "material" to another individual's decision to "purchase or s[ell]" a statutorily defined "security" or "covered security." And the relevant statements or omissions were material to a transaction in the relevant securities by or on behalf of someone other than the fraudster.

Second, the Government points out that §10(b) of the Securities Exchange Act also uses the phrase "in connection with the purchase or sale of any security." And the Government warns that a narrow interpretation of "in connection with" here threatens a similarly narrow interpretation there, which could limit the SEC's enforcement capabilities.

We do not understand, however, how our interpretation could significantly curtail the SEC's enforcement powers. As far as the Government has explained the matter, our interpretation seems perfectly consistent with past SEC practice. For one thing, we have cast no doubt on the SEC's ability to bring enforcement actions against Stanford and Stanford International Bank. The SEC has already done so successfully. As we have repeatedly pointed out, the term "security" under §10(b) covers a wide range of financial products beyond those traded on national exchanges, apparently including the Bank's certificates of deposit at issue in these cases. No one here denies that, for §10(b) purposes, the "material" misrepresentations by Stanford and his associates were made "in connection with" the "purchases" of those certificates.

We find it surprising that the dissent worries that our decision will "narro[w] and constric[t] essential protection for our national securities market," and put "frauds like the one here . . . not within the reach of federal regulation." That would be news to Allen Stanford, who was sentenced to 110 years in federal prison after a successful federal prosecution, and to Stanford International Bank, which was ordered to pay billions in federal fines, after the same. Frauds like the one here – including *this fraud itself* – will continue to be within the reach of federal regulation because the authority of the SEC and Department of Justice extends to all "securities," not just to those traded on national exchanges. . . . When the fraudster peddles an uncovered security like the CDs here, the Federal Government will have the full scope of its usual powers to act. The only difference between our approach and that of the dissent, is that we *also* preserve the ability for investors to obtain relief under state laws when the fraud bears so remote a connection to the national securities market that no person actually believed he was taking an ownership position in that market.

Thus, despite the Government's and the dissent's hand wringing, neither has been able to point to an example of any prior SEC enforcement action brought during the past 80 years that our holding today would have prevented the SEC from bringing. . . .

For these reasons, the dissent's warning that our decision will "inhibit" "litigants from using federal law to police frauds" and will "undermine the primacy of federal law in policing abuses in the securities markets" rings hollow. The dissent cannot point to one example of a federal securities action – public or private – that would have been permissible in the past but that our approach will disallow in the future. And the irony of the dissent's position is that federal law would have *precluded* private recovery in these very suits, because §10(b) does not create a private right of action for investors vis-à-vis "secondary actors" or "aiders and abettors" of securities fraud. . . .

III

Respondents' complaints specify that their claims rest upon their purchases of uncovered, not of covered, securities. Our search for allegations that might bring their allegations within the scope of the Litigation Act reveals the following:

(1) The first set of Texas plaintiffs alleged that they bought certificates of deposit from Stanford International Bank because they were told "the CDs issued by SIB were safer even than U. S. bank-issued CDs" and "could be redeemed at any time," given that the Bank "only invested the money [*i.e.*, the Bank's money obtained from its certificate sale proceeds] in safe, secure, and liquid assets." They claimed Stanford "touted the high quality of SIB's investment portfolio," and such falsehoods were material to their decision to purchase the uncovered certificates.

(2) The second set of Texas plaintiffs contended that they, too, purchased the Bank's certificates on the belief "that their money was being invested in safe, liquid investments." They alleged that the Bank's marketing materials stated it devoted "the greater part of its assets" to "first grade investment bonds (AAA, AA+, AA) and shares of stock (of great reputation, liquidity, and credibility)."

(3) Both groups of Louisiana plaintiffs alleged that they were induced to purchase the certificates based on misrepresentations that the Bank's assets were

"`invested in a well-diversified portfolio of highly marketable securities issued by stable governments, strong multinational companies and major international banks.'" And they claimed the "`liquidity/marketability of SIB's invested assets'" was "the most important factor to provide security to SIB clients."

These statements do not allege, for Litigation Act purposes, misrepresentations or omissions of material fact "in connection with" the "purchase or sale of a covered security." At most, the complaints allege misrepresentations about the *Bank's* ownership of covered securities— fraudulent assurances that the Bank owned, would own, or would use the victims' money to buy *for itself* shares of covered securities. But the Bank is an entity that made the misrepresentations. The Bank is the fraudster, not the fraudster's victim. Nor is the Bank some other person transacting (or refraining from transacting) in covered securities. And consequently, there is not the necessary "connection" between the materiality of the misstatements and the statutorily required "purchase or sale of a covered security."

A final point: The District Court found that one of the plaintiffs acquired Bank certificates "with the proceeds of selling" covered securities contained in his IRA portfolio. . . . The plaintiffs, however, did not allege that the sale of these covered securities (which were used to finance the purchase of the certificates) constituted any part of the fraudulent scheme. Nor did the complaints allege that

Stanford or his associates were at all interested in how the plaintiffs obtained the funds they needed to purchase the certificates. Thus, we agree with the Court of Appeals that "[u]nlike *Bankers Life* and *Zandford*, where the entirety of the fraud depended upon the tortfeasor convincing the victims of those fraudulent schemes to sell their covered securities in order for the fraud to be accomplished, the allegations here are not so tied with the sale of covered securities." In our view, like that of the Court of Appeals, these sales constituted no relevant part of the fraud but were rather incidental to it.

For these reasons the Court of Appeals' judgment is affirmed.

It is so ordered.

CHAPTER 12

§ 12.04 "Tipper-Tippee" Liability

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UNITED STATES v. NEWMAN

773 F. 3d 438 (2d Cir. 2014)

BARRINGTON D. PARKER, Circuit Judge.

Defendants-appellants Todd Newman and Anthony Chiasson appeal from judgments of conviction entered on May 9, 2013, and May 14, 2013, respectively in the United States District Court for the Southern District of New York (Richard J. Sullivan, *J.*) following a six-week jury trial on charges of securities fraud in violation of sections 10(b) and 32 of the Securities Exchange Act of 1934 (the "1934 Act"), and 18 U.S.C. § 2, and conspiracy to commit securities fraud in violation of 18 U.S.C. § 371.

The Government alleged that a cohort of analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of publicly traded technology companies, shared it amongst each other, and subsequently passed this information to the portfolio managers at their respective companies. The Government charged Newman, a portfolio manager at Diamondback Capital Management, LLC ("Diamondback"), and Chiasson, a portfolio manager at Level Global Investors, L.P. ("Level Global"), with willfully participating in this insider trading scheme by trading in securities based on the inside information illicitly obtained by this group of analysts. On appeal, Newman and Chiasson challenge the sufficiency of the evidence as to several elements of the offense, and further argue that the district court erred in failing to instruct the jury that it must find that a tippee knew that the insider disclosed confidential information in exchange for a personal benefit.

We agree that the jury instruction was erroneous because we conclude that, in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit. Moreover, we hold that the evidence was insufficient to sustain a guilty verdict against Newman and Chiasson for two reasons. *First,* the Government's evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants' purported tippee liability would derive. *Second,* even assuming that the scant evidence offered on the issue of personal benefit was sufficient, which we conclude it was not, the Government presented no evidence that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties.

Accordingly, we reverse the convictions of Newman and Chiasson on all counts and remand with instructions to dismiss the indictment as it pertains to them with prejudice.

BACKGROUND

This case arises from the Government's ongoing investigation into suspected insider trading activity at hedge funds. . . .

At trial, the Government presented evidence that a group of financial analysts exchanged information they obtained from company insiders, both directly and more often indirectly. Specifically, the Government alleged that these analysts received information from insiders at Dell and NVIDIA disclosing those companies' earnings numbers before they were publicly released in Dell's May 2008 and August 2008 earnings announcements and NVIDIA's May 2008 earnings announcement. These analysts then passed the inside information to their portfolio managers, including Newman and Chiasson, who, in turn, executed trades in Dell and NVIDIA stock, earning approximately $4 million and $68 million, respectively, in profits for their respective funds.

Newman and Chiasson were several steps removed from the corporate insiders and there was no evidence that either was aware of the source of the inside information. With respect to the Dell tipping chain, the evidence established that Rob Ray of Dell's investor relations department tipped information regarding Dell's consolidated earnings numbers to Sandy Goyal, an analyst at Neuberger Berman. Goyal in turn gave the information to Diamondback analyst Jesse Tortora. Tortora in turn relayed the information to his manager Newman as well as to other analysts including Level Global analyst Spyridon "Sam" Adondakis. Adondakis then passed along the Dell information to Chiasson, making Newman and Chiasson three and four levels removed from the inside tipper, respectively.

With respect to the NVIDIA tipping chain, the evidence established that Chris Choi of NVIDIA's finance unit tipped inside information to Hyung Lim, a former executive at technology companies Broadcom Corp. and Altera Corp., whom Choi knew from church. Lim passed the information to co-defendant Danny Kuo, an analyst at Whittier Trust. Kuo circulated the information to the group of analyst friends, including Tortora and Adondakis, who in turn gave the information to Newman and Chiasson, making Newman and Chiasson four levels removed from the inside tippers.

Although Ray and Choi have yet to be charged administratively, civilly, or criminally for insider trading or any other wrongdoing, the Government charged that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose.

At the close of evidence, Newman and Chiasson moved for a judgment of acquittal pursuant to Federal Rule of Criminal Procedure 29. They argued that there was no evidence that the corporate insiders provided inside information in exchange for a personal benefit which is required to establish tipper liability under *Dirks v. S.E.C.,* 463 U.S. 646 (1983). Because a tippee's liability derives from the liability of the tipper, Newman and Chiasson argued that they could not be found guilty of insider trading. Newman and Chiasson also argued that, even if the corporate insiders had received a personal benefit in exchange for the inside information, there was no evidence that they knew about any such benefit. Absent such knowledge, appellants argued, they were not aware of, or participants in, the tippers' fraudulent breaches of fiduciary duties to Dell or NVIDIA, and could not be convicted of insider trading under *Dirks.* In the alternative, appellants requested that the court instruct the jury that it must find that Newman and Chiasson knew that the corporate insiders had disclosed confidential information for personal benefit in order to find them guilty.

The district court [declined to give the requested jury instructions].

On December 17, 2012, the jury returned a verdict of guilty on all counts. . . .

On May 2, 2013, the district court sentenced Newman to an aggregate term of 54 months' imprisonment, to be followed by one year of supervised release, imposed a $500 mandatory special assessment, and ordered Newman to pay a $1 million fine and to forfeit $737,724. On May 13, 2013, the district court sentenced Chiasson to an aggregate term of 78 months' imprisonment, to be followed by one year of supervised release, imposed a $600 mandatory special assessment, and ordered him to pay a $5 million fine and forfeiture in an amount not to exceed $2 million. This appeal followed.

DISCUSSION

Newman and Chiasson raise a number of arguments on appeal. Because we conclude that the jury instructions were erroneous and that there was insufficient evidence to support the convictions, we address only the arguments relevant to these issues. . . .

I. The Law of Insider Trading

Section 10(b) of the 1934 Act prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . ." Although Section 10(b) was designed as a catch-all clause to prevent fraudulent practices, neither the statute nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibit insider trading. Rather, the unlawfulness of insider trading is predicated on the notion that insider trading is a type of securities fraud proscribed by Section 10(b) and Rule 10b-5. . . .

A. The "Classical" and "Misappropriation" Theories of Insider Trading

The classical theory holds that a corporate insider (such as an officer or director) violates Section 10(b) and Rule 10b-5 by trading in the corporation's securities on the basis of material, nonpublic information about the corporation. Under this theory, there is a special "relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position within that corporation." As a result of this relationship, corporate insiders that possess material, nonpublic information have "a duty to disclose [or to abstain from trading] because of the `necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders.'"

In accepting this theory of insider trading, the Supreme Court explicitly rejected the notion of "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." Instead, the Court limited the scope of insider trading liability to situations where the insider had "a duty to disclose arising from a relationship of trust and confidence between parties to a transaction," such as that between corporate officers and shareholders.

An alternative, but overlapping, theory of insider trading liability, commonly called the "misappropriation" theory, expands the scope of insider trading liability to certain other "outsiders," who do not have any fiduciary or other relationship to a corporation or its shareholders. Liability may attach where an "outsider" possesses material non-public information about a corporation and another person uses that information to trade in breach of a duty owed to the owner. . . . In other words, such conduct violates Section 10(b) because the misappropriator engages in deception by pretending "loyalty to the principal while secretly converting the principal's information for personal gain.". . .

B. Tipping Liability

The insider trading case law, however, is not confined to insiders or misappropriators who trade for their own accounts. Courts have expanded insider trading liability to reach situations where the insider or misappropriator in possession of material nonpublic information (the "tipper") does not himself trade but discloses the information to an outsider (a "tippee") who then trades on the basis of the information before it is publicly disclosed. The elements of tipping liability are the same, regardless of whether the tipper's duty arises under the "classical" or the "misappropriation" theory. . . .

In *Dirks*, the Supreme Court addressed the liability of a tippee analyst who received material, nonpublic information about possible fraud at an insurance company from one of the insurance company's former officers. The analyst relayed the information to some of his clients who were investors in the insurance company, and some of them, in turn, sold their shares based on the analyst's tip. The SEC charged the analyst Dirks with aiding and abetting securities fraud by relaying confidential and material inside information to people who traded the stock.

In reviewing the appeal, the Court articulated the general principle of tipping liability: "Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.". . . The test for determining whether the corporate insider has breached his fiduciary duty "is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, *there has been no breach of duty* . . . ."

The Supreme Court rejected the SEC's theory that a recipient of confidential information (i.e. the "tippee") must refrain from trading "whenever he receives inside information from an insider." Instead, the Court held that "[t]he tippee's duty to disclose or abstain is derivative from that of the insider's duty." Because the *tipper's* breach of fiduciary duty requires that he "personally will benefit, directly or indirectly, from his disclosure," a tippee may not be held liable in the absence of such benefit. Moreover, the Supreme Court held that a tippee may be found liable "only when the insider has breached his fiduciary duty . . . *and* the tippee knows or should know that there has been a breach." In *Dirks,* the corporate insider provided the confidential information in order to expose a fraud in the company and not for any personal benefit, and thus, the Court found that the insider had not breached his duty to the company's shareholders and that Dirks could not be held liable as tippee.

E. Mens Rea

Liability for securities fraud also requires proof that the defendant acted with scienter, which is defined as "a mental state embracing intent to deceive, manipulate or defraud." In order to establish a criminal violation of the securities laws, the Government must show that the defendant acted "willfully." We have defined willfulness in this context "as a realization on the defendant's part that he was doing a wrongful act under the securities laws.". . .

II. The Requirements of Tippee Liability

The Government concedes that tippee liability requires proof of a personal benefit to the insider. However, the Government argues that it was not required to prove that Newman and Chiasson knew that the insiders at Dell and NVIDIA received a personal benefit in order to be found guilty of insider trading. Instead, the Government contends, consistent with the district court's instruction, that it merely needed to prove that the "defendants traded on material, nonpublic information they knew insiders had disclosed in breach of a duty of confidentiality. . . ."

In support of this position, the Government cites *Dirks* for the proposition that the Supreme Court only required that the "tippee know that the tipper disclosed information in *breach of a duty*." In addition, the Government relies on dicta in a number of our decisions post-*Dirks,* in which we have described the elements of tippee liability without specifically stating that the Government must prove that the tippee knew that the corporate insider who disclosed confidential information did so for his own personal benefit. . . . By selectively parsing this dictum, the Government seeks to revive the absolute bar on tippee trading that the Supreme Court explicitly rejected in *Dirks.*

Although this Court has been accused of being "somewhat Delphic" in our discussion of what is required to demonstrate tippee liability, the Supreme Court was quite clear in *Dirks. First,* the tippee's liability derives *only* from the tipper's breach of a fiduciary duty, *not* from trading on material, non-public information. . . . *Second,* the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure. *Third,* even in the presence of a tipper's breach, a tippee is liable only if he knows or should have known of the breach.

While we have not yet been presented with the question of whether the tippee's knowledge of a tipper's breach requires knowledge of the tipper's personal benefit, the answer follows naturally from *Dirks. Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability for securities fraud under Rule 10b-5. For purposes of ` insider trading liability, the insider's disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.

The Government's overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders. By contrast, our prior cases generally involved tippees who directly participated in the tipper's breach (and therefore had knowledge of the tipper's disclosure for personal benefit) or tippees who were explicitly apprised of the tipper's gain by an intermediary tippee. *See, e.g., Jiau*, 734 F.3d 147, 150 (2d Cir. 2013) ("To provide an incentive, Jiau promised the tippers insider information for their own private trading."); *United States v. Falcone,* 257 F.3d 226, 235 (2d Cir. 2001) (affirming conviction of remote tipper where intermediary tippee paid the inside tipper and had told remote tippee "the details of the scheme"); *Warde*, 151 F.3d 42, 49 (2d Cir. 1998) (tipper and tippee engaged in parallel trading of the inside information and "discussed not only the inside information, but also the best way to profit from it"); *United States v. Mylett*, 97 F.3d 663 (2d Cir. 1996) (tippee acquired inside information directly from his insider friend). We note that the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading.

Jiau illustrates the importance of this distinction quite clearly. In *Jiau*, the panel was presented with the question of whether the evidence at trial was sufficient to prove that the tippers personally benefitted from their disclosure of insider information. In that context, we summarized the elements of criminal liability as follows:

> (1) the insider-tippers . . . were entrusted the duty to protect confidential information, which (2) they breached by disclosing [the information] to their tippee . . ., who (3) knew of [the tippers'] duty and (4) still used the information to trade a security or further tip the information for [the tippee's] benefit, and finally (5) the insider-tippers benefited in some way from their disclosure. . . .

Jiau, 734 F.3d at 152-53. . . . The Government relies on this language to argue that *Jiau* is merely the most recent in a string of cases in which this Court has found that a tippee, in order to be criminally liable for insider trading, need know only that an insider-tipper disclosed information in breach of a duty of confidentiality. However, we reject the Government's position that our cursory recitation of the elements in *Jiau* suggests that criminal liability may be imposed on a defendant based only on knowledge of a breach of a duty of confidentiality. In *Jiau,* the defendant knew about the benefit because she provided it. For that reason, we had no need to reach the question of whether knowledge of a breach requires that a tippee know that a personal benefit was provided to the tipper.

In light of *Dirks,* we find no support for the Government's contention that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability. Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets. The Supreme Court explicitly repudiated this premise not only in *Dirks,* but in a predecessor case, *Chiarella v. United States.* In *Chiarella,* the Supreme Court rejected this Circuit's conclusion that "the federal securities laws have created a system providing equal access to information necessary for reasoned and intelligent investment decisions. . . . because [material non-public] information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers." The Supreme

Court emphasized that "[t]his reasoning suffers from [a] defect. . . . [because] not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." . . . Thus, in both *Chiarella* and *Dirks,* the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation's interests in confidentiality while promoting efficiency in the nation's securities markets.

As noted above, *Dirks* clearly defines a breach of fiduciary duty as a breach of the duty of confidentiality in exchange for a personal benefit. *Accordingly, we conclude that a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit.* [emphasis supplied]. . . .

Our conclusion also comports with well-settled principles of substantive criminal law. As the Supreme Court explained in *Staples v. United States,* 511 U.S. 600, 605 (1994), under the common law, *mens rea,* which requires that the defendant know the facts that make his conduct illegal, is a necessary element in every crime. Such a requirement is particularly appropriate in insider trading cases where we have acknowledged "it is easy to imagine a . . . trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful." This is also a statutory requirement, because only "willful" violations are subject to criminal provision. . . .

In sum, we hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit. . . . [emphasis supplied]

In view of this conclusion, we find, reviewing the charge as a whole, that the district court's instruction failed to accurately advise the jury of the law. The district court charged the jury that the Government had to prove: (1) that the insiders had a "fiduciary or other relationship of trust and confidence" with their corporations; (2) that they "breached that duty of trust and confidence by disclosing material, nonpublic information"; (3) that they "personally benefited in some way" from the disclosure; (4) "that the defendant . . . knew the information he obtained had been disclosed in breach of a duty"; and (5) that the defendant used the information to purchase a security. Under these instructions, a reasonable juror might have concluded that a defendant could be criminally liable for insider trading merely if such defendant knew that an insider had divulged information that was required to be kept confidential. But a breach of the duty of confidentiality is not fraudulent unless the tipper acts for personal benefit, that is to say, there is no breach unless the tipper "is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself. . . ." Thus, the district court was required to instruct the jury that the Government had to prove beyond a reasonable doubt that Newman and Chiasson knew that the tippers received a personal benefit for their disclosure.

The Government argues that any possible instructional error was harmless because the jury could have found that Newman and Chiasson inferred from the circumstances that some benefit was provided to (or anticipated by) the insiders. We disagree.

An instructional error is harmless only if the Government demonstrates that it is "clear beyond a reasonable doubt that a rational jury would have found the defendant guilty absent the error[.]" The harmless error inquiry requires us to view whether the evidence introduced was "uncontested and supported by overwhelming evidence" such that it is "clear beyond a reasonable doubt that a rational jury would have found the defendant guilty absent the error." Here both Chiasson and Newman contested their knowledge of any benefit received by the tippers and, in fact, elicited evidence sufficient to support a contrary finding. Moreover, we conclude that the Government's evidence of any personal benefit received by the insiders was insufficient to establish tipper liability from which Chiasson and Newman's purported tippee liability would derive.

III. Insufficiency of the Evidence

As a general matter, a defendant challenging the sufficiency of the evidence bears a heavy burden, as the standard of review is exceedingly deferential. Specifically, we "must view the evidence in the light most favorable to the Government, crediting every inference that could have been drawn in the Government's favor, and deferring to the jury's assessment of witness credibility and its assessment of the weight of the evidence." Although sufficiency review is *de novo,* we will uphold the judgments of conviction if "any rational trier of fact could have found the essential elements of the crime beyond a reasonable doubt." . . . This standard of review draws no distinction between direct and circumstantial evidence. The Government is entitled to prove its case solely through circumstantial evidence, provided, of course, that the Government still demonstrates each element of the charged offense beyond a reasonable doubt.

However, if the evidence "is nonexistent or so meager," such that it "gives equal or nearly equal circumstantial support to a theory of guilt and a theory of innocence, then a reasonable jury must necessarily entertain a reasonable doubt."

Because few events in the life of an individual are more important than a criminal conviction, we continue to consider the "beyond a reasonable doubt" requirement with utmost seriousness. Here, we find that the Government's evidence failed to reach that threshold, even when viewed in the light most favorable to it.

The circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips. As to the Dell tips, the Government established that Goyal and Ray were not "close" friends, but had known each other for years, having both attended business school and worked at Dell together. Further, Ray, who wanted to become a Wall Street analyst like Goyal, sought career advice and assistance from Goyal. The evidence further showed that Goyal advised Ray on a range of topics, from discussing the qualifying examination in order to become a financial analyst to editing Ray's résumé and sending it to a Wall Street recruiter, and that some of this assistance began before Ray began to provide tips about Dell's earnings. The evidence also established that Lim and Choi were "family friends" that had met through church and occasionally socialized together. The Government argues that these facts were sufficient to prove that the tippers derived some benefit from the tip. We disagree. If this was a "benefit," practically anything would qualify.

We have observed that "[p]ersonal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia*, any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." This standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature. If that were true, and the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity. To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades "resemble trading by the insider himself followed by a gift of the profits to the recipient," we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. In other words, as Judge Walker noted in *Jiau,* this requires evidence of "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter]." *Jiau,* 734 F. 3d at 153.

While our case law at times emphasizes language from *Dirks* indicating that the tipper's gain need not be *immediately* pecuniary, it does not erode the fundamental insight that, in order to form the basis for a fraudulent breach, the personal benefit received in exchange for confidential information must be of some consequence. For example, in *Jiau,* we noted that at least one of the corporate insiders received something more than the ephemeral benefit of the "value[] [of] [Jiau's] friendship" because he also obtained access to an investment club where stock tips and insight were routinely discussed. Thus, by joining the investment club, the tipper entered into a relationship of *quid quo pro* with Jiau, and therefore had the opportunity to access information that could yield future pecuniary gain. *See also SEC v. Yun*, 327 F.3d 1263, 1280 (11th Cir. 2003) (finding evidence of personal benefit where tipper and tippee worked closely together in real estate deals and commonly split commissions on various real estate transactions); *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (finding evidence of personal benefit when the tipper passed information to a friend who referred others to the tipper for dental work).

Here the "career advice" that Goyal gave Ray, the Dell tipper, was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance. . . . Crucially, Goyal testified that he would have given Ray advice without receiving information because he routinely did so for industry colleagues. Although the Government argues that the jury could have reasonably inferred from the evidence that Ray and Goyal swapped career advice for inside information, Ray himself disavowed that any such *quid pro quo* existed. Further, the evidence showed Goyal began giving Ray "career advice" over a year before

Ray began providing any insider information. Thus, it would not be possible under the circumstances for a jury in a criminal trial to find beyond a reasonable doubt that Ray received a personal benefit in exchange for the disclosure of confidential information. . . .

The evidence of personal benefit was even more scant in the NVIDIA chain. Choi and Lim were merely casual acquaintances. The evidence did not establish a history of loans or personal favors between the two. During cross examination, Lim testified that he did not provide anything of value to Choi in exchange for the information. Lim further testified that Choi did not know that Lim was trading NVIDIA stock (and in fact for the relevant period Lim did not trade stock), thus undermining any inference that Choi intended to make a "gift" of the profits earned on any transaction based on confidential information.

Even assuming that the scant evidence described above was sufficient to permit the inference of a personal benefit, which we conclude it was not, the Government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts. As discussed above, the Government is required to prove beyond a reasonable doubt that Newman and Chiasson knew that the insiders received a personal benefit in exchange for disclosing confidential information.

It is largely uncontroverted that Chiasson and Newman, and even their analysts, who testified as cooperating witnesses for the Government, knew next to nothing about the insiders and nothing about what, if any, personal benefit had been provided to them. Adondakis said that he did not know what the relationship between the insider and the first-level tippee was, nor was he aware of any personal benefits exchanged for the information, nor did he communicate any such information to Chiasson. Adondakis testified that he merely told Chiasson that Goyal "was talking to someone within Dell," and that a friend of a friend of Tortora's would be getting NVIDIA information. Adondakis further testified that he did not specifically tell Chiasson that the source of the NVIDIA information worked at NVIDIA. Similarly, Tortora testified that, while he was aware Goyal received information from someone at Dell who had access to "overall" financial numbers, he was not aware of the insider's name, or position, or the circumstances of how Goyal obtained the information. Tortora further testified that he did not know whether Choi received a personal benefit for disclosing inside information regarding NVIDIA.

The Government now invites us to conclude that the jury could have found that the appellants knew the insiders disclosed the information "for some personal reason rather than for no reason at all." But the Supreme Court affirmatively rejected the premise that a tipper who discloses confidential information necessarily does so to receive a personal benefit. *See Dirks,* 463 U.S. at 661-62 ("All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders"). Moreover, it is inconceivable that a jury could conclude, beyond a reasonable doubt, that Newman and Chiasson were aware of a personal benefit, when Adondakis and Tortora, who were more intimately involved in the insider trading scheme as part of the "corrupt" analyst group, disavowed any such knowledge.

Alternatively, the Government contends that the specificity, timing, and frequency of the updates provided to Newman and Chiasson about Dell and NVIDIA were so "overwhelmingly suspicious" that they warranted various material inferences that could support a guilty verdict. Newman and Chiasson received four updates on Dell's earnings numbers in the weeks leading up to its August 2008 earnings announcement. Similarly, Newman and Chiasson received multiple updates on NVIDIA's earnings numbers between the close of the quarter and the company's earnings announcement. The Government argues that given the detailed nature and accuracy of these updates, Newman and Chiasson must have known, or deliberately avoided knowing, that the information originated with corporate insiders, *and* that those insiders disclosed the information in exchange for a personal benefit. We disagree.

Even viewed in the light most favorable to the Government, the evidence presented at trial undermined the inference of knowledge in several ways. The evidence established that analysts at hedge funds routinely estimate metrics such as revenue, gross margin, operating margin, and earnings per share through legitimate financial modeling using publicly available information and educated assumptions about industry and company trends. For example, on cross-examination, cooperating witness Goyal testified that under his financial model on Dell, when he ran the model in January 2008 without any inside information, he calculated May 2008 quarter results of $16.071 billion revenue, 18.5% gross margin, and $0.38 earnings per share. These estimates came very close to Dell's reported earnings of $16.077 billion revenue; 18.4% gross margin, and $0.38 earnings per share. Appellants also elicited testimony from the cooperating witnesses and investor relations associates that analysts routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements. Goyal testified that he frequently spoke to internal relations departments to run his model by them and ask whether his assumptions were "too high or too low" or in the "ball park," which suggests analysts routinely updated numbers in advance of the earnings announcements. Ray's supervisor confirmed that investor relations departments routinely assisted analysts with developing their models.

Moreover, the evidence established that NVIDIA and Dell's investor relations personnel routinely "leaked" earnings data in advance of quarterly earnings. Appellants introduced examples in which Dell insiders, including the head of Investor Relations, Lynn Tyson, selectively disclosed confidential quarterly financial information arguably similar to the inside information disclosed by Ray and Choi to establish relationships with financial firms who might be in a position to buy Dell's stock. For example, appellants introduced an email Tortora sent Newman summarizing a conversation he had with Tyson in which she suggested "low 12% opex [was] reasonable" for Dell's upcoming quarter and that she was "fairly confident on [operating margin] and [gross margin]."

No reasonable jury could have found beyond a reasonable doubt that Newman and Chiasson knew, or deliberately avoided knowing, that the information originated with corporate insiders. In general, information about a firm's finances could certainly be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source. But in this case, where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source, the inference that defendants knew, or should have known, that the information originated with a corporate insider is unwarranted.

Moreover, even if detail and specificity could support an inference as to the *nature* of the source, it cannot, without more, permit an inference as to that source's improper *motive* for disclosure. That is especially true here, where the evidence showed that corporate insiders at Dell and NVIDIA regularly engaged with analysts and routinely selectively disclosed the same type of information. Thus, in light of the testimony (much of which was adduced from the Government's own witnesses) about the accuracy of the analysts' estimates and the selective disclosures by the companies themselves [evidently in violation of SEC Regulation FD], no rational jury would find that the tips were so overwhelmingly suspicious that Newman and Chiasson either knew or consciously avoided knowing that the information came from corporate insiders or that those insiders received any personal benefit in exchange for the disclosure.

In short, the bare facts in support of the Government's theory of the case are as consistent with an inference of innocence as one of guilt. Where the evidence viewed in the light most favorable to the prosecution gives equal or nearly equal circumstantial support to a theory of innocence as a theory of guilt, that evidence necessarily fails to establish guilt beyond a reasonable doubt. Because the Government failed to demonstrate that Newman and Chiasson had the intent to commit insider trading, it cannot sustain the convictions on either the substantive insider trading counts or the conspiracy count. *United States v. Gaviria,* 740 F.2d 174, 183 (2d Cir. 1984) ("[W]here the crime charged is conspiracy, a conviction cannot be sustained unless the Government establishes beyond a reasonable doubt that the defendant had the specific intent to violate the substantive statute.") . . . Consequently, we reverse Newman and Chiasson's convictions and remand with instructions to dismiss the indictment as it pertains to them.

CONCLUSION

For the foregoing reasons, we vacate the convictions and remand for the district court to dismiss the indictment with prejudice as it pertains to Newman and Chiasson.

CHAPTER 15

SECURITIES LAW ENFORCEMENT

§ 15.08[A] SEC SETTLEMENTS

page 1089 add:

SEC v. CITIGROUP GLOBAL MARKETS, INC.

United States Court of Appeals

2014 U.S. App. LEXIS 10516 (2d Cir. 2014)

Pooler, Circuit Judge:

The United States Securities and Exchange Commission ("S.E.C.") in conjunction with Citigroup Global Markets, Inc. ("Citigroup") appeals from the November 28, 2011 order of the United States District Court for the Southern District of New York (Rakoff, J.) refusing to approve a consent decree entered into by the parties and instead setting a trial date. Our Court stayed that order and referred the matter to a merits panel for consideration of the underlying questions. . . . We now hold that the district court abused its discretion by applying an incorrect legal standard in assessing the consent decree and setting a date for trial.

BACKGROUND

Complaint and Proposed Consent Judgment

In October 2011, the S.E.C. filed a complaint against Citigroup, alleging that Citigroup negligently misrepresented its role and economic interest in structuring and marketing a billion-dollar fund, known as the Class V Funding III ("the Fund"), and violated Sections 17(a)(2) and (3) of the Securities Act of 1933 (the "Act"). The complaint alleges that Citigroup "exercised significant influence" over the selection of $500 million worth of the Fund's assets, which were primarily collateralized by subprime securities tied to the already faltering U.S. housing market. Citigroup told Fund investors that the Fund's investment portfolio was chosen by an independent investment advisor, but, the S.E.C. alleged, Citigroup itself selected a substantial amount of negatively projected mortgage-backed assets in which Citigroup had taken a short position. By assuming a short position, Citigroup realized profits of roughly $160 million from the poor performance of its chosen assets, while Fund investors suffered millions of dollars in losses.

Shortly after filing of the complaint, the S.E.C. filed a proposed consent judgment. In the proposed consent judgment, Citigroup agreed to: (1) a permanent injunction barring Citigroup from violating Act Sections 17(a)(2) and (3); (2) disgorgement of $160 million, which the S.E.C. asserted were Citigroup's net profits gained as a result of the conduct alleged in the complaint; (3) prejudgment interest in the amount of $30 million; and (4) a civil penalty of $95 million. Citigroup also agreed not to seek an offset against any compensatory damages awarded in any related investor action. Citigroup consented to make internal changes, for a period of three years, to prevent similar acts from happening in the future. Absent from the consent decree was any admission of guilt or liability.

The S.E.C. also filed a parallel complaint against Citigroup employee Brian Stoker. . . . The Stoker complaint alleged that Stoker negligently violated Sections 17(a)(2) and (3) of the Act in connection with his role in structuring and marketing the collateralized debt obligations in the Fund.

Proceedings Before the District Court

The district court scheduled a hearing in the matter, and presented the S.E.C. and Citigroup with a list of questions to answer. The questions included:

- Why should the Court impose a judgment in a case in which the S.E.C. alleges a serious securities fraud but the defendant neither admits nor denies wrongdoing?
- Given the S.E.C.'s statutory mandate to ensure transparency in the financial marketplace, is there an overriding public interest in determining whether the S.E.C.'s charges are true? Is the interest even stronger when there is no parallel criminal case?

• How was the amount of the proposed judgment determined? In particular, what calculations went into the determination of the $95 million penalty? Why, for example, is the penalty in this case less than one-fifth of the $535 million penalty assessed in S.E.C. v. Goldman Sachs & Co.? What reason is there to believe this proposed penalty will have a meaningful deterrent effect?

• The proposed judgment imposes injunctive relief against future violations. What does the S.E.C. do to maintain compliance? How many contempt proceedings against large financial entities has the S.E.C. brought in the past decade as a result of violations of prior consent judgments?

• Why is the penalty in this case to be paid in large part by Citigroup and its shareholders rather than by the "culpable individual offenders acting for the corporation?" If the S.E.C. was for the most part unable to identify such alleged offenders, why was this?

• How can a securities fraud of this nature and magnitude be the result simply of negligence?

Both the S.E.C. and Citigroup submitted written responses to the district court's questions. On November 9, 2011, the district court conducted a hearing to explore the questions presented. A few weeks later, the district court issued a written opinion declining to approve the consent judgment. *S.E.C. v. Citigroup*

Global Markets Inc., 827 F.Supp.2d 328 (S.D.N.Y.2011) (*"Citigroup I"*). The district court stated that

> before a court may employ its injunctive and contempt powers in support of an administrative settlement, it is required, even after giving substantial deference to the views of the administrative agency, to be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest.

[The district court] found that the proposed consent decree

> is neither fair, nor reasonable, nor adequate, nor in the public interest . . . because it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards. Purely private parties can settle a case without ever agreeing on the facts, for all that is required is that a plaintiff dismiss his complaint. But when a public agency asks a court to become its partner in enforcement by imposing wide-ranging injunctive remedies on a defendant, enforced by the formidable judicial power of contempt, the court, and the public, need some knowledge of what the underlying facts are: for otherwise, the court becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance.

The district court criticized the relief obtained by the S.E.C. in the consent decree, comparing it unfavorably with settlements entered in [two other enforcement actions] In [these two actions, namely,] *Bank of America and Goldman Sachs*, the district court noted, the parties stipulated to certain findings of facts. Without such an evidentiary basis in this case, the district court reasoned, "the Court is forced to conclude that a proposed Consent Judgment that asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever, is neither reasonable, nor fair, nor adequate, nor in the public interest."

Thus, the district court concluded:

> An application of judicial power that does not rest on facts is worse than mindless, it is inherently dangerous. The injunctive power of the judiciary is not a free-roving remedy to be invoked at the whim of a regulatory agency, even with the consent of the regulated. If its deployment does not rest on facts – cold, hard, solid facts, established either by admissions or by trials – it serves no lawful or moral purpose and is simply an engine of oppression.

The district court refused to approve the consent judgment, and instead consolidated this case with the Stoker action and ordered the parties to be prepared to try both cases. . . .

. . . .

ANALYSIS

We review the district court's denial of a settlement agreement under an abuse of discretion standard. A district court abuses its discretion if it "(1) based its ruling on an erroneous view of the law," (2) made a "clearly erroneous assessment of the evidence," or (3) "rendered a decision that cannot be located within the range of permissible decisions."

The Scope of the Consent Decree

We quickly dispense with the argument that the district court abused its discretion by requiring Citigroup to admit liability as a condition for approving the consent decree. In both the briefing and at oral argument, the district court's pro bono counsel stated that the district court did not seek an admission of liability before approving the consent decree. With good reason – there is no basis in the law for the district court to require an admission of liability as a condition for approving a settlement between the parties. The decision to require an admission of liability before entering into a consent decree rests squarely with the S.E.C. As the district court did not condition its approval of the consent decree on an admission of liability, we need not address the issue further.

The Scope of Deference

We turn, then, to the far thornier question of what deference the district court owes an agency seeking a consent decree. Our Court recognizes a "strong federal policy favoring the approval and enforcement of consent decrees." "To be sure, when the district judge is presented with a proposed consent judgment, he is not merely a 'rubber stamp.'" The district court here found it was "required, even after giving substantial deference to the views of the administrative agency, to be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest." . . . Other district courts in our Circuit view "[t]he role of the Court in reviewing and approving proposed consent judgments in S.E.C. enforcement actions [as] 'restricted to assessing whether the settlement is fair, reasonable and adequate within the limitations Congress has imposed on the S.E.C. to recover investor losses.'". . .

The "fair, reasonable, adequate and in the public interest" standard invoked by the district court finds its origins in a variety of cases. Our Court previously held, in the context of assessing a plan for distributing the proceeds of a proposed disgorgement order, that "once the district court satisfies itself that the distribution of proceeds in a proposed S.E.C. disgorgement plan is fair and reasonable, its review is at an end." The Ninth Circuit – in circumstances similar to those presented here, a proposed consent decree aimed at settling an S.E.C. enforcement action – noted that "[u]nless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved." S.E.C. v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984).

Today we clarify that the proper standard for reviewing a proposed consent judgment involving an enforcement agency requires that the district court determine whether the proposed consent decree is fair and reasonable, with the additional requirement that the "public interest would not be disserved," in the event that the consent decree includes injunctive relief. Absent a substantial basis in the record for concluding that the proposed consent decree does not meet these requirements, the district court is required to enter the order.

We omit "adequacy" from the standard. Scrutinizing a proposed consent decree for "adequacy" appears borrowed from the review applied to class action settlements, and strikes us as particularly inapt in the context of a proposed S.E.C. consent decree. See Fed. R. Civ. P. 23(e)(2) ("If the proposal would bind the class members, the court may approve it only after a hearing and on a finding that it is fair, reasonable, and adequate."). The adequacy requirement makes perfect sense in the context of a class action settlement – a class action settlement typically precludes future claims, and a court is rightly concerned that the settlement achieved be adequate. By the same token, a consent decree does not pose the same concerns regarding adequacy – if there are potential plaintiffs with a private right of action, those plaintiffs are free to bring their own actions. If there is no private right of action, then the S.E.C. is the entity charged with representing the victims, and is politically liable if it fails to adequately perform its duties.

A court evaluating a proposed S.E.C. consent decree for fairness and reasonableness should, at a minimum, assess (1) the basic legality of the decree. . . . (2) whether the terms of the decree, including its enforcement mechanism, are clear. . . . (3) whether the consent decree reflects a resolution of the actual claims in the complaint; and (4) whether the consent decree is tainted by improper collusion or corruption of some kind. . . . Consent decrees vary, and depending on the decree a district court may need to make additional inquiry to ensure that the consent decree is fair and reasonable. The primary focus of the inquiry, however, should be on ensuring the consent decree is procedurally proper, using objective measures similar to the factors set out above, taking care not to infringe on the S.E.C.'s discretionary authority to settle on a particular set of terms.

It is an abuse of discretion to require, as the district court did here, that the S.E.C. establish the "truth" of the allegations against a settling party as a condition for approving the consent decrees. Trials are primarily about the truth. Consent decrees are primarily about pragmatism. "[C]onsent decrees are normally compromises in which the parties give up something they might have won in litigation and waive their rights to litigation." *United States v. ITT Continental Baking Co.*, 420 U.S. 223, 235 (1975). Thus, a consent decree "must be construed as . . . written, and not as it might have been written had the plaintiff established his factual claims and legal theories in litigation." . . . Consent decrees provide parties with a means to manage risk. "The numerous factors that affect a litigant's decision whether to compromise a case or litigate it to the end include the value of the particular proposed compromise, the perceived likelihood of obtaining a still better settlement, the prospects of coming out better, or worse, after a full trial, and the resources that would need to be expended in the attempt." These assessments are uniquely for the litigants to make. It is not within the district court's purview to demand "cold, hard, solid facts, established either by admissions or by trials," as to the truth of the allegations in the complaint as a condition for approving a consent decree.

As part of its review, the district court will necessarily establish that a factual basis exists for the proposed decree. In many cases, setting out the colorable claims, supported by factual averments by the S.E.C., neither admitted nor denied by the wrongdoer, will suffice to allow the district court to conduct its review. Other cases may require more of a showing, for example, if the district court's initial review of the record raises a suspicion that the consent decree was entered into as a result of improper collusion between the S.E.C. and the settling party. We need not, and do not, delineate the precise contours of the factual basis required to obtain approval for each consent decree that may pass before the court. It is enough to state that the district court here, with the benefit of copious submissions by the parties, likely had a sufficient record before it on which to determine if the proposed decree was fair and reasonable. On remand, if the district court finds it necessary, it may ask the S.E.C. and Citigroup to provide additional information sufficient to allay any concerns the district court may have regarding improper collusion between the parties.

As noted earlier, when a proposed consent decree contains injunctive relief, a district court must also consider the public interest in deciding whether to grant the injunction. *See eBay*, *547 U.S. at 391*. . . . eBay makes clear that

> a plaintiff seeking a permanent injunction must satisfy a four-factor test before a court may grant such relief. A plaintiff must demonstrate: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.

. . . "eBay strongly indicates that the traditional principles of equity it employed are the presumptive standard for injunctions in any context," be they preliminary or permanent. . . .

Our analysis focuses on the issue reached by the district court: that the district court must assure itself the "public interest would not be disserved" by the issuance of a permanent injunction. . . .

The job of determining whether the proposed S.E.C. consent decree best serves the public interest, however, rests squarely with the S.E.C., and its decision merits significant deference:

> [F]ederal judges – who have no constituency – have a duty to respect legitimate policy choices made by those who do. The responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones: "Our Constitution vests such responsibilities in the public branches."

. . . .

The district court correctly recognized that it was required to consider the public interest in deciding whether to grant the injunctive relief in the proposed injunction. However, the district court made no findings that the injunctive relief proposed in the consent decree would disserve the public interest, in part because it defined the public interest as "an overriding interest in knowing the truth." The district court's failure to make the proper inquiry constitutes legal error. On remand, the district court should consider whether the public interest would be disserved by entry of the consent decree. For example, a consent decree may disserve the public interest if it barred private litigants from pursuing their own claims independent of the relief obtained under the consent decree. What the district court may not do is find the public interest disserved based on its disagreement with the S.E.C.'s decisions on discretionary matters of policy, such as deciding to settle without requiring an admission of liability.

To the extent the district court withheld approval of the consent decree on the ground that it believed the S.E.C. failed to bring the proper charges against Citigroup, that constituted an abuse of discretion. In comparing the complaint filed by the S.E.C. against Citigroup with the complaint filed by the S.E.C. against Stoker, the district court noted that "[a]lthough this would appear to be tantamount to an allegation of knowing and fraudulent intent ('scienter,' in the lingo of securities law), the S.E.C., for reasons of its own, chose to charge Citigroup only with negligence, in violation of Sections 17(a)(2) and (3) of the Securities Act. . . ." The exclusive right to choose which charges to levy against a defendant rests with the S.E.C. . . . Nor can the district court reject a consent decree on the ground that it fails to provide collateral estoppel assistance to private litigants – that simply is not the job of the courts.

Finally, we note that to the extent that the S.E.C. does not wish to engage with the courts, it is free to eschew the involvement of the courts and employ its own arsenal of remedies instead. . . . The S.E.C. can also order the disgorgement of profits. . . . Admittedly, these remedies may not be on par with the relief afforded by a so-ordered consent decree and federal court injunctions. But if the S.E.C. prefers to call upon the power of the courts in ordering a consent decree and issuing an injunction, then the S.E.C. must be willing to assure the court that the settlement proposed is fair and reasonable. "Consent decrees are a hybrid in the sense that they are at once both contracts and orders; they are construed largely as contracts, but are enforced as orders." . . . For the courts to simply accept a proposed S.E.C. consent decree without any review would be a dereliction of the court's duty to ensure the orders it enters are proper.

CONCLUSION

For the reasons given above, we vacate the order of the district court and remand this case for further proceedings in accordance with this opinion. . . .

Lohier, Circuit Judge concurring:

I thank my panel colleagues for addressing many of my concerns in this case. In particular, today's majority opinion makes clear that district courts assessing a proposed consent decree should consider principally four factors: "(1) the basic legality of the decree; (2) whether the terms of the decree, including its enforcement mechanism, are clear; (3) whether the consent decree reflects a resolution of the actual claims in the complaint; and (4) whether the consent decree is tainted by improper collusion or corruption of some kind." . . . I write separately to make two more observations.

First, in my view, the "fair and reasonable" standard for assessing the appropriateness of monetary relief (as opposed to injunctive relief) involves a straightforward analysis of *only* the four factors identified by the majority and described above. If all four factors are satisfied, the perceived modesty of monetary penalties proposed in a consent decree is not a reason to reject the decree.

Second, I would be inclined to reverse on the factual record before us and direct the District Court to enter the consent decree. It does not appear that any additional facts are needed to determine that the proposed decree is "fair and reasonable" and does not disserve the public interest. Nor, to use the words of the majority opinion's holding, is there a "substantial basis . . . for concluding" that further development of the record will show that the proposed terms of this decree are not fair, reasonable, and in the public interest. Under the circumstances, though, it does no harm to vacate and remand to permit the very able and distinguished District Judge to make that determination in the first instance.

§ 15.10 ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT DOCTRINE

[A] In General

page 1103 add:

IN RE: KELLOGG BROWN & ROOT, INC.

United States Court of Appeals

2014 WL 2895939 (D.C. Cir. 2014)

KAVANAUGH, *Circuit Judge*: More than three decades ago, the Supreme Court held that the attorney-client privilege protects confidential employee communications made during a business's internal investigation led by company lawyers. *See Upjohn Co. v. United States*, 449 U.S. 383 (1981). In this case, the District Court denied the protection of the privilege to a company that had conducted just such an internal investigation. The District Court's decision has generated substantial uncertainty about the scope of the attorney-client privilege in the business setting. We conclude that the District Court's decision is irreconcilable with *Upjohn*. We therefore grant KBR's petition for a writ of mandamus and vacate the District Court's document production order.

I

Harry Barko worked for KBR, a defense contractor. In 2005, he filed a False Claims Act complaint against KBR and KBR-related corporate entities, whom we will collectively refer to as KBR. In essence, Barko alleged that KBR and certain subcontractors defrauded the U.S. Government by inflating costs and accepting kickbacks while administering military contracts in wartime Iraq. During discovery, Barko sought documents related to KBR's prior internal investigation into the alleged fraud. KBR had conducted that internal investigation pursuant to its Code of Business Conduct, which is overseen by the company's Law Department.

KBR argued that the internal investigation had been conducted for the purpose of obtaining legal advice and that the internal investigation documents therefore were protected by the attorney-client privilege. Barko responded that the internal investigation documents were unprivileged business records that he was entitled to discover. . . .

After reviewing the disputed documents *in camera*, the District Court determined that the attorney-client privilege protection did not apply because, among other reasons, KBR had not shown that "the communication would not have been made 'but for' the fact that legal advice was sought.". . . KBR's internal investigation, the court concluded, was "undertaken pursuant to regulatory law and corporate policy rather than for the purpose of obtaining legal advice." . . .

KBR vehemently opposed the ruling. The company asked the District Court to certify the privilege question to this Court for interlocutory appeal and to stay its order pending a petition for mandamus in this Court. The District Court denied those requests and ordered KBR to produce the disputed documents to Barko within a matter of days. . . . KBR promptly filed a petition for a writ of mandamus in this Court. A number of business organizations and trade associations also objected to the District Court's decision and filed an amicus brief in support of KBR. We stayed the District Court's document production order and held oral argument on the mandamus petition.

. . . .

II

We . . . consider whether the District Court's privilege ruling was legally erroneous. We conclude that it was.

Federal Rule of Evidence 501 provides that claims of privilege in federal courts are governed by the "common law—as interpreted by United States courts in the light of reason and experience." Fed. R. Evid. 501. The attorney-client privilege is the "oldest of the privileges for confidential communications known to the common law." *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981). As relevant here, the privilege applies to a confidential communication between attorney and client if that communication was made for the purpose of obtaining or providing legal advice to the client. . . .

In *Upjohn*, the Supreme Court held that the attorney-client privilege applies to corporations. The Court explained that the attorney-client privilege for business organizations was essential in light of "the vast and complicated array of regulatory legislation confronting the modern corporation," which required corporations to "constantly go to lawyers to find out how to obey the law, . . . particularly since compliance with the law in this area is hardly an instinctive matter." The Court stated, moreover, that the attorney-client privilege "exists to protect not only the giving of professional advice to those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice." That is so, the Court said, because the "first step in the resolution of any legal problem is ascertaining the factual background and sifting through the facts with an eye to the legally relevant." In *Upjohn*, the communications were made by company employees to company attorneys during an attorney-led internal investigation that was undertaken to ensure the company's "compliance with the law." The Court ruled that the privilege applied to the internal investigation and covered the communications between company employees and company attorneys.

KBR's assertion of the privilege in this case is materially indistinguishable from Upjohn's assertion of the privilege in that case. As in *Upjohn*, KBR initiated an internal investigation to gather facts and ensure compliance with the law after being informed of potential misconduct. And as in *Upjohn*, *KBR's investigation was conducted under the auspices of KBR's in-house legal department, acting in its legal capacity*. [emphasis supplied] The same considerations that led the Court in *Upjohn* to uphold the corporation's privilege claims apply here.

The District Court in this case initially distinguished *Upjohn* on a variety of grounds. But none of those purported distinctions takes this case out from under *Upjohn*'s umbrella.

First, the District Court stated that in *Upjohn* the internal investigation began after in-house counsel conferred with outside counsel, whereas here the investigation was conducted in-house without consultation with outside lawyers. But *Upjohn* does not hold or imply that the involvement of outside counsel is a necessary predicate for the privilege to apply. On the contrary, the general rule, which this Court has adopted, is that a lawyer's status as in-house counsel "does not dilute the privilege.". . . As the [American Law Institute] Restatement's commentary points out, "Inside legal counsel to a corporation or similar organization . . . is fully empowered to engage in privileged communications." 1 Restatement [The Law Governing Lawyers] § 72, cmt. c, at 551.

Second, the District Court noted that in *Upjohn* the interviews were conducted by attorneys, whereas here many of the interviews in KBR's investigation were conducted by non-attorneys. But the investigation here was conducted at the direction of the attorneys in KBR's Law Department. And communications made by and to non-attorneys serving as agents of attorneys in internal investigations are routinely protected by the attorney-client privilege. . . . *Third*, the District Court pointed out that in *Upjohn* the interviewed employees were expressly informed that the purpose of the interview was to assist the company in obtaining legal advice, whereas here they were not. The District Court further stated that the confidentiality agreements signed by KBR employees did not mention that the purpose of KBR's investigation was to obtain legal advice. Yet nothing in *Upjohn* requires a company to use magic words to its employees in order to gain the benefit of the privilege for an internal investigation. And in any event, here, as in *Upjohn*, employees knew that the company's legal department was conducting an investigation of a sensitive nature and that the information they disclosed would be protected. KBR employees were also told not to discuss their interviews "without the specific advance authorization of KBR General Counsel."

. . .

In short, none of those three distinctions of *Upjohn* holds water as a basis for denying KBR's privilege claim.

More broadly and more importantly, the District Court also distinguished *Upjohn* on the ground that KBR's internal investigation was undertaken to comply with Department of Defense regulations that require defense contractors such as

KBR to maintain compliance programs and conduct internal investigations into allegations of potential wrongdoing. The District Court therefore concluded that the purpose of KBR's internal investigation was to comply with those regulatory requirements rather than to obtain or provide legal advice. In our view, the District Court's analysis rested on a false dichotomy. So long as obtaining or providing legal advice was one of the significant purposes of the internal investigation, the attorney-client privilege applies, even if there were also other purposes for the investigation and even if the investigation was mandated by regulation rather than simply an exercise of company discretion.

The District Court began its analysis by reciting the "primary purpose" test, which many courts (including this one) have used to resolve privilege disputes when attorney-client communications may have had both legal and business purposes. But in a key move, the District Court then said that the primary purpose of a communication is to obtain or provide legal advice only if the communication would not have been made "but for" the fact that legal advice was sought. In other words, if there was any other purpose behind the communication, the attorney-client privilege apparently does not apply. The District Court went on to conclude that KBR's internal investigation was "undertaken pursuant to regulatory law and corporate policy rather than for the purpose of obtaining legal advice." . . .

The District Court erred because it employed the wrong legal test. The but-for test articulated by the District Court is not appropriate for attorney-client privilege analysis. Under the District Court's approach, the attorney-client privilege apparently would not apply unless the sole purpose of the communication was to obtain or provide legal advice. That is not the law. We are aware of no Supreme Court or court of appeals decision that has adopted a test of this kind in this context. The District Court's novel approach to the attorney-client privilege would eliminate the attorney-client privilege for numerous communications that are made for both legal and business purposes and that heretofore have been covered by the attorney-client privilege. And the District Court's novel approach would eradicate the attorney-client privilege for internal investigations conducted by businesses that are required by law to maintain compliance programs, which is now the case in a significant swath of American industry. In turn, businesses would be less likely to disclose facts to their attorneys and to seek legal advice, which would "limit the valuable efforts of corporate counsel to ensure their client's compliance with the law." We reject the District Court's but-for test as inconsistent with the principle of *Upjohn* and longstanding attorney-client privilege law.

Given the evident confusion in some cases, we also think it important to underscore that the primary purpose test, sensibly and properly applied, cannot and does not draw a rigid distinction between a legal purpose on the one hand and a business purpose on the other. After all, trying to find *the* one primary purpose for a communication motivated by two sometimes overlapping purposes (one legal and one business, for example) can be an inherently impossible task. It is often not useful or even feasible to try to determine whether the purpose was A or B when the purpose was A and B. It is thus not correct for a court to presume that a communication can have only one primary purpose. It is likewise not correct for a court to try to find *the* one primary purpose in cases where a given communication plainly has multiple purposes. Rather, it is clearer, more precise, and more predictable to articulate the test as follows: Was obtaining or providing legal advice *a* primary purpose of the communication, meaning one of the significant purposes of the communication? As the Reporter's Note to the Restatement says, "In general, American decisions agree that the privilege applies if one of the significant purposes of a client in communicating with a lawyer is that of obtaining legal assistance." 1 Restatement § 72, Reporter's Note, at 554. We agree with and adopt that formulation—"one of the significant purposes"—as an accurate and appropriate description of the primary purpose test. Sensibly and properly applied, the test boils down to whether obtaining or providing legal advice was one of the significant purposes of the attorney-client communication.

In the context of an organization's internal investigation, if one of the significant purposes of the internal investigation was to obtain or provide legal advice, the privilege will apply. That is true regardless of whether an internal investigation was conducted pursuant to a company compliance program required by statute or regulation, or was otherwise conducted pursuant to company policy. . . .

In this case, there can be no serious dispute that one of the significant purposes of the KBR internal investigation was to obtain or provide legal advice. In denying KBR's privilege claim on the ground that the internal investigation was conducted in order to comply with regulatory requirements and corporate policy and not just to obtain or provide legal advice, the District Court applied the wrong legal test and clearly erred.

. . . .

In reaching our decision here, we stress, as the Supreme Court did in *Upjohn*, that the attorney-client privilege "only protects disclosure of communications; it does not protect disclosure of the underlying facts by those who communicated with the attorney." *Upjohn Co. v. United States*, 449 U.S. 383, 395 (1981). Barko was able to pursue the facts underlying KBR's investigation. But he was not entitled to KBR's own investigation files. As the *Upjohn* Court stated, quoting Justice Jackson, "Discovery was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from the adversary." *Id.* at

396 (quoting *Hickman v. Taylor*, 329 U.S. 495, 515 (1947) (Jackson, J., concurring)).

Although the attorney-client privilege covers only communications and not facts, we acknowledge that the privilege carries costs. The privilege means that potentially critical evidence may be withheld from the factfinder. Indeed, as the District Court here noted, that may be the end result in this case. But our legal system tolerates those costs because the privilege "is intended to encourage 'full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and the administration of justice.' "

We grant the petition for a writ of mandamus and vacate the District Court's . . . document production order . . . .