09-4414

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

MOHAMMED FEZZANI ET AL.,
Plaintiffs-Appellants,

v.

BEAR, STEARNS & CO., INC. ET AL.,
Defendants-Appellees.

On Appeal from United States District Court
for the Southern District of New York

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION
AS AMICUS CURIAE SUPPORTING
THE PETITION FOR REHEARING OR REHEARING EN BANC

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STATEMENT OF INTEREST

The Securities and Exchange Commission enforces the federal securities laws, including the anti-manipulation provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5. The Commission has a substantial interest in rehearing because of the implications of the divided panel's decision for private plaintiffs seeking relief under those provisions and for the Commission's enforcement program, which is supplemented by such private actions.

ISSUE PRESENTED

Whether a defendant, who enters into sham securities transactions designed to give the false appearance of market activity, cannot be held liable for manipulation under Rule 10b-5 unless that defendant also makes false or misleading statements.

DISCUSSION

As alleged in the complaint, Isaac Dweck was a key participant in A.R. Baron's "paradigmatic 'pump and dump' scheme." Slip op. 4. Dweck entered into "parking" arrangements: he nominally "purchased" shares from Baron, which agreed to repurchase them later, retained all risk of loss, and compensated Dweck for his role. *In re Gellas*, Rel. No. 34-39132, 1997 SEC Lexis 2001, at *3 n.2 (Sept. 25, 1997) ("Parking is the sale of securities subject to an agreement or understanding that the securities will be repurchased by the seller at a later time and at a price which leaves the economic risk on the seller."). These parking transactions served no legitimate purpose; they were designed only "to create a false appearance of volume and

increasing price." Slip op. 4. Under Second Circuit precedent, well-pleaded allegations of such direct acts of manipulation would state a claim under Rule 10b-5.

Yet a panel of this Court affirmed the dismissal of plaintiffs' manipulation claim against Dweck—over Judge Lohier's dissent—because even though plaintiffs alleged that "Dweck was a primary violator" who "engaged directly in market manipulation," they did not allege that he made any false or misleading statements regarding pricing information. Dissent at 2. This ruling erroneously "conflates market manipulation claims and pure misrepresentation claims," deviates from Supreme Court precedent, generates an intracircuit split, and imposes an unprecedented requirement for establishing manipulation claims that will "unnecessarily" provide "extra shelter for stock manipulation under the federal security laws." *Id.* at 1, 10. Rehearing is necessary to maintain uniformity of this Court's decisions and to resolve the important question that divided the panel.

I. Misrepresentations are not prerequisites for manipulation claims.

The majority erred because its opinion "superimposes the elements of a misrepresentation claim on a market manipulation claim." Dissent at 3. Section 10(b) prohibits the use of "any manipulative or deceptive practice or contrivance," 15 U.S.C. 78j(b), and the use of "the word 'manipulative' is especially significant." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976). It is "'virtually a term of art when used in connection with securities markets.'" *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977), quoting *Ernst*, 425 U.S. at 199. It "refers generally to practices, such as wash

sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity," *id.*, which "artificially affect[s] the price of securities," *Ernst*, 425 U.S. at 199 & n.21.

While a manipulative scheme may involve false or misleading statements, it is not correct that "only the person who communicates the misrepresentation" may be liable for acts of manipulation undertaken in furtherance of that scheme. Slip op. 13. The essence of manipulation is not a misrepresentation, but market activity—the buying and selling of shares—that itself creates a "false pricing signal." *ATSI Communs., Inc. v. Shaar Fund, LTD*, 493 F.3d 87, 100 (2d Cir. 2007). A manipulative transaction, such as parking, is an "intentional interference with the free forces of supply and demand." *In re Pagel, Inc.*, 48 S.E.C. 223, 226 (1985), *aff'd,* 803 F.2d 942 (8th Cir. 1986), citing *United States v. Stein*, 456 F.2d 844, 850 (2d Cir. 1972); *In re Halsey, Stuart & Co.*, 30 S.E.C. 106, 112 (1949). Investors are "entitled to assume that the prices they pay and receive are determined by the unimpeded interaction of real supply and real demand." But manipulative transactions "frustrate these expectations," substituting "fiction for fact" and transforming a market "into 'a stage managed performance.'" *In re Edward J. Mawod & Co.*, 46 S.E.C. 865, 871–72 (1977), *aff'd*, 591 F.2d 588 (10th Cir. 1979).

By conflating manipulative conduct with misrepresentations, the panel disregarded the Supreme Court's recognition of a distinction between the two. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008); *Central*

Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177 (1994). This Court has similarly recognized that engaging in manipulative acts—practices "that are intended to mislead investors by artificially affecting market activity"—are violations distinct from making "misrepresentations." *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000). Emphasizing that distinction is this Court's ruling that a manipulation claim requires "*market activity* aimed at deceiving investors as to how other market participants have valued a security." *ATSI,* 493 F.3d at 99–100, 105 (emphasis added).[1]

Manipulation and misrepresentation claims also differ with respect to reliance, which private plaintiffs (but not the Commission) must show. For misrepresentation claims, plaintiffs must establish that they engaged in a transaction "based on that specific misrepresentation." *Amgen Inc. v. Connecticut Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1192 (2013) (internal quotation marks omitted). For manipulation claims, by contrast, plaintiffs must establish that the conduct sent "a false pricing signal to the market" and that plaintiffs then bought or sold assuming that the price was "'determined by the natural interplay of supply and demand, not rigged by

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[1] This distinction between manipulative conduct and misstatements is echoed in the differences between the three subparts of Rule 10b-5. *Van Cook v. SEC*, 653 F.3d 130, 138–41 (2d Cir. 2011), *cert. denied* 132 S. Ct. 1582 (2012). Rule 10b-5(a) makes it unlawful "[t]o employ any device, scheme, or artifice to defraud," and Rule 10b-5(c) makes it unlawful "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." Rule 10b-5(b) is narrower: it states that it "shall be unlawful" to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. 240.10b-5.

manipulators.'" *ATSI*, 493 F.3d at 100–01, quoting *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999). Thus, plaintiffs must show that they suffered damage "caused by reliance on an assumption of an efficient market free of manipulation." *Id.* at 106.

Conflating these two types of claims, the majority held that a plaintiff must establish that an artificial price "is communicated to persons who, in reliance upon a misrepresentation that the price was set by market forces, purchase the securities." Slip op. 13. Dweck engaged in sham transactions that artificially inflated the price, but did not directly communicate any pricing information to plaintiffs. Thus, the majority held, plaintiffs failed "to allege reliance upon a misrepresentation." *Id.* at 11.

This ruling "mistakenly" focused on "who actually communicated the false price to the plaintiffs" and viewed "the answer to that question as dispositive." Dissent at 7. But the "relevant analysis" is "whether a defendant has engaged" in the transaction that sends "'a false pricing signal to the market.'" *Id.* at 5, quoting *ATSI*, 493 F.3d at 100. It is not, as the majority stated, whether the defendant is the source of plaintiffs' "perceptions of prices at which trades were being made." Slip op. 10.[2]

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[2] It is unclear why the majority assumed that plaintiffs claimed reliance on Baron's statements about the price, as opposed to the price itself. Slip op. 6. As the Commission previously found, and as judicially noticeable material confirms (*i.e.*, news items, trading records, and public filings), the relevant securities traded "in the over-the-counter markets" (*i.e.*, NASDAQ) and on AMEX. *In re Bear, Stearns Secs. Corp.*, 54 S.E.C. 224, 228 (1999). For those securities, information about price was publicly available, and Baron would not have been "the sole sources" of plaintiffs' "perceptions of prices at which trades were being made." Slip op. 9–10. Indeed, it is difficult to fathom why Baron would go to the trouble of paying Dweck for parking unless those transactions sent a false pricing signal that was publicly reported.

The majority's ruling would shield from liability those who create the illusion of a functioning market simply because investors learn about prices from another source. This is a novel proposition because misrepresentations about price have never been a requirement for a viable manipulation claim. Even before the Exchange Act, courts condemned sham transactions that artificially inflated the price because they created "a kind of price mirage which may lure an outsider into the market," causing him to pay more "than he would have paid in a free and open market." *United States v. Brown*, 5 F. Supp. 81, 85, 93 (S.D.N.Y. 1933), *aff'd* 79 F.2d 321 (2d Cir. 1935), cited by A.A. Berle, Jr., *Stock Market Manipulation*, 38 COLUM. L. REV. 393, 395–97 (1938); *cf. Harper v. Crenshaw*, 82 F.2d 845, 846 (D.C. Cir. 1936) (a contract having "as its object the fixing of a fictitious price" was against public policy because it prevented "the free and uncontrolled processes" of the market). The Exchange Act built upon this foundation, outlawing manipulative acts regardless of whether those who engage in such acts also make false statements to investors. *E.g.*, *SEC v. U.S. Envt'l Inc.*, 155 F.3d 107 (2d Cir. 1998); *Thornton v. SEC*, 171 F.2d 702 (2d Cir. 1948) (per curiam).[3] Indeed, the types of manipulative acts that spurred the enactment of Section 10(b)

[3] *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964 (S.D.N.Y. 1973); *In re Kirlin Secs.*, Rel. No. 34-61135, 2009 SEC Lexis 4168, at *52 (Dec. 10, 2009) (finding by Commission that the respondent's trades, which were designed to inflate price, constituted manipulative conduct in violation of Rule 10b-5 even though the respondent did not communicate pricing information to investors); *In re F.S. Johns & Co.*, 43 S.E.C. 124, 136–37 (1966), *aff'd sub nom. Dlugash v. SEC*, 373 F.2d 107 (2d Cir. 1967) (finding by Commission that brokers who submitted false quotations to artificially inflate the price engaged in manipulation, even though there was "no evidence that the quotations were shown to members of the public to induce purchases at the quoted prices," because, as the Commission found, the "transactions in themselves [were] sufficient to establish violations").

"did not depend on communication at all, but rather on the brute force of concentrated economic resources." Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 413 (1990).

II. Rehearing is necessary to avoid conflict with Supreme Court precedent and to ensure uniformity with this Court's prior decisions.

The requirement that a defendant "communicat[e] the artificial price information to the would-be buyers," slip op. 13, imposes a new requirement for manipulation that deviates from Supreme Court and Second Circuit precedent.

A. The majority's decision conflicts with Supreme Court precedent.

The majority's ruling cannot be reconciled with the decisions in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972) and *Stoneridge*. In *Affiliated Ute*, the defendants induced the sale of stock that was subject to restrictions without disclosing to the sellers that defendants had created a market in which the stock could be resold for a greater profit. 406 U.S. at 152–53. The Court disagreed that there was no Rule 10b-5 violation "unless the record disclosed evidence of reliance on material fact misrepresentations" made by those defendants. *Id.* at 152. The Court refused to "read Rule 10b-5 so restrictively" because while "the second sub paragraph of the rule [Rule 10b-5(b)] specifies the making of an untrue statement of a material fact," the "first and third sub paragraphs [Rule 10b-5(a), (c)] are not so restricted." *Id.* at 152–53. Even though the defendants "may have made no positive representations" to the

sellers, their conduct still violated Rule 10b-5 because it constituted "a 'course of business' or a 'device, scheme, or artifice' that operated as a fraud." *Id.* at 153.

The majority's decision also conflicts with *Stoneridge*. The Court there declared it "erroneous" to conclude that "there must be a specific oral or written statement before there could be liability under [Section] 10(b) or Rule 10b-5." 552 U.S. at 158. Rather, the Court stated, "[c]onduct itself can be deceptive." *Id.*; *see also Central Bank*, 511 U.S. at 191.

The majority understood *Stoneridge*, as well as *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), to instruct that "only the person who communicates the misrepresentation is liable." Slip op. 13. But, as Judge Lohier stated, *Stoneridge* and *Janus* "did no such thing." Dissent at 6. The majority, in becoming the first federal court to apply those decisions "to foreclose a claim against an actor alleged to have engaged directly in market manipulation," overlooked the fact that neither *Stoneridge* nor *Janus* "require[s] a direct communication of either a false statement or deceptive conduct to specific plaintiffs" as a precondition to stating a *manipulation claim* under Rule 10b-5. *Id.* at 6–7.

The investors in *Stoneridge* brought suit against "entities who, acting both as customers and suppliers [of a cable television company], agreed to arrangements that allowed the investors' company to mislead its auditor and issue a misleading financial statement affecting the stock price." 552 U.S. at 152. More specifically, the cable company agreed to overpay for cable boxes with the understanding that the cable box

manufacturers would then overpay for advertising, helping the cable company to show that it had met its revenue projections. *Id.* at 154. The Court rejected the argument that the investors relied upon these arrangements because they allowed the cable company to produce a false financial statement; the Court held that the arrangements were "purchase and supply contracts" that fell into "the realm of ordinary business operations" and were "too remote to satisfy the requirement of reliance." *Id.* at 161. The Court did not fashion a broad rule requiring a plaintiff alleging manipulation to also allege that the defendant "was identified as making the pertinent misrepresentation(s)." Slip op. 11. Rather, the Court emphasized that the allegedly deceptive acts, which involved the sale of cable boxes and advertising, "took place in the marketplace for goods and services, not in the investment sphere," and that "nothing [the manufacturers] did made it necessary or inevitable for [the cable company] to record the transactions as it did" because the cable company "was free to do as it chose" when "preparing and then issuing its financial statements." *Stoneridge*, 552 U.S. at 161, 166–67.

By contrast, Dweck's prearranged, riskless parking arrangements were transactions "in the investment sphere." *Stoneridge*, 552 U.S. at 166. And Dweck's conduct was hardly "remote." *Id.* at 161. Dweck "was central to the manipulation itself"—he "effectively was a founder, principal, and owner of Baron"—and the sham transactions from which he profited were central to the scheme because they "directly" gave "the public the false impression that Dweck, not Baron, controlled the

relevant manipulated securities." Dissent at 3, 7–8. The majority elides the difference between a sham *business* transaction used to support a false accounting statement and a sham *securities* transaction that directly affects the price of the securities and perpetuates the illusion of a fair market. Unlike the defendant in *Stoneridge*, Dweck "engaged directly in market manipulation of securities," Dissent at 7, and thus is liable as a primary violator, even if he did not communicate with investors.

Janus is also inapposite. That case "involved discrete misrepresentations relating to defendants' business operations, rather than a market manipulation scheme." Dissent at 6. The Supreme Court, interpreting the word "make" in subpart (b) of Rule 10b-5, held that only "the entity with authority over the content of the statement and whether and how to communicate it" can "make" a material misstatement. *Janus*, 131 S. Ct. at 2301, 2303. *Janus* is a pure misrepresentation case; the Court assessed liability "for false statements" and decided that "[o]ne who prepares or publishes a statement on behalf of another is not its maker." *Id.* at 2302. The Court did not address manipulation (the word does not appear in the majority opinion), it did not discuss the elements of such a claim, and it did not decide that "only the person who communicates the misrepresentation" may be liable for manipulation. Slip op. 13.

B. The majority's decision also creates an intracircuit split.

Rehearing is also necessary to maintain uniformity of this Court's decisions. The decision conflicts with *ATSI*, where the plaintiffs alleged both manipulation and

misrepresentation claims, and the Court articulated different elements for each. In *ATSI*, the Court stated that a manipulation claim requires allegations, *inter alia*, of "(1) manipulative acts" and "(2) damage (3) caused by reliance on an assumption of an efficient market free of manipulation." 493 F.3d at 101. *ATSI* followed *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999), where the Court stated that a plaintiff asserting a manipulation claim may show reliance by establishing "that he or she engaged in a securities trade in ignorance of the fact that the price was affected by the alleged manipulation." The Court did not require plaintiffs to establish "reliance upon a misrepresentation that the price was set by market forces." Slip op. 13. Rather, the Court addressed the allegations about false statements in a separate section using a separate standard for reliance. *ATSI*, 493 F.3d at 105.[4]

The intracircuit split grows even starker when the majority's decision is juxtaposed with *U.S. Environmental*. In that case, the Commission alleged that a registered representative of a broker-dealer executed manipulative trades—including the same type of risk-free trades at issue here—that created the appearance of a market for securities and, consequently, inflated their price. 155 F.3d at 108–09. As

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[4] The majority's ruling also conflicts with decisions that follow *ATSI*. *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120 (2d Cir. 2011); *Cellular South Inc. v. Merrill, Lynch*, 2013 U.S. App. Lexis 5356 (2d Cir. Mar. 19, 2013) (unpublished); *Finn v. Barney*, 471 Fed. Appx. 30 (2d Cir. 2012) (unpublished). And it conflicts with other Second Circuit opinions that, similar to *ATSI*, distinguish between manipulation claims and misrepresentation claims. *Van Cook*, 653 F.3d at 138, 139–40 (discussing the difference between misrepresentation claims under Rule 10b-5(b), and manipulation claims under Rule 10b-5(a) and (c)); *United States v. Royer*, 549 F.3d 886, 900 (2d Cir. 2008) (distinguishing between "conventional frauds brought about by making materially false or misleading statements" and manipulative acts); *United States v. Russo*, 74 F.3d 1383, 1391–92 (2d Cir. 1996) (same).

in plaintiffs' complaint against Dweck, there were no allegations that the representative communicated pricing information to investors. The absence of such misstatements did not lead to dismissal; this Court held that the Commission had stated a manipulation claim because the representative executed "the very buy and sell orders that artificially manipulated" the price. *Id.* at 112. As the Court stated, "if the trader who executes manipulative buy and sell orders is not a primary violator, it is difficult to imagine who would remain liable after *Central Bank*." *Id.*[5]

III. The Court should grant rehearing because the majority's decision creates a significant obstacle for investors bringing private actions and may be applied to impair Commission enforcement actions.

The petition for rehearing presents an issue of "exceptional importance"—and should be granted—because the panel decision will sharply limit the ability of investors to recover damages when they purchase securities at prices inflated by sham transactions. The majority's decision raises the bar considerably. Even though this Court has previously stated that a "plaintiff need not plead manipulation to the same degree of specificity as a plain misrepresentation claim," *ATSI*, 493 F.3d at 102, the majority's decision requires a plaintiff to allege not only that the defendant engaged in manipulative acts, but also that the defendant communicated pricing information directly to the plaintiff.

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[5] This holding is consistent with Commission orders finding that individuals who make manipulative trades violate Rule 10b-5. *E.g.*, *In re Montelbano*, 56 S.E.C. 76, 87, 91–92 (2003) (trader "placed the quotations and effected the buy and sell orders that arbitrarily moved the price of [the] stock up and down"); *In re Yoshikawa*, Rel. No. 34-53731, 2006 SEC Lexis 948, at *15–20 (Apr. 26, 2006).

Plaintiffs here alleged that Dweck "engaged in parking transactions with the purpose and effect of creating a false appearance of an active trading market with the intent of inflating the trading price of [the securities] and causing investors, such as plaintiffs to purchase [them]." First Am. Compl. ¶ 10; *accord id.* ¶¶ 21, 131, 251, 293, 319. Judge Lohier believed that such allegations (along with other allegations describing the parking transactions) were adequate under prior Second Circuit precedent to establish that plaintiffs "acted in reliance on an assumption of an efficient market free of manipulation when they purchased the securities at artificially inflated prices." Dissent at 9. Yet, under the majority's rule, these allegations are not enough—a determination that "unnecessarily provides" an "extra shelter for stock manipulation under the federal securities laws." *Id.* at 10.

The Commission is also concerned that the decision could be applied in a way that would impair its ability to bring manipulation claims. While the majority's decision arises in the context of a private action, appears to focus on reliance (which only private plaintiffs must establish), and expressly recognizes that plaintiffs' allegations "would easily be sufficient" in a Commission action premised upon a theory of secondary liability, slip op. 14, the broad language used in the opinion to impose a new misrepresentation requirement for manipulation claims is not ostensibly limited to private actions. For instance, when the majority states that "an allegation of acts facilitating or even indispensable to a fraud is not sufficient to state a claim if

those acts were not the particular misrepresentations that deceived the investor," *id.* at 11–12, it does not clearly restrict this language to private actions.

Moreover, the majority's decision may also affect the Commission's ability to proceed under a theory of secondary liability because the Commission can only bring an aiding and abetting claim if there is a primary violator. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996). Under the majority's view, a manipulation claim requires a defendant to communicate pricing information to the plaintiff. In this case, Baron's officers and employees communicated with investors, and thus there is a primary violation upon which Dweck's secondary liability may be premised. But not every instance of manipulation will involve someone who, acting with scienter, makes false statements about price to directly to investors.

Such a shield from liability is inconsistent with the Exchange Act and Rule 10b-5. The Exchange Act was a direct response to manipulation in the securities markets; in Section 2(e), which explains the "[n]ecessity for [r]egulation," Congress described the economic and social ills that result when "the prices of securities" on exchanges and over-the-counter markets "are susceptible to manipulation and control." 15 U.S.C. 78b(3). Congress enacted Section 10(b)—and authorized the Commission to promulgate Rule 10b-5—to ensure that "supply and demand may freely meet at prices uninfluenced by manipulation and control." S. REP. NO. 73-1455, at 30 (1934). Congress used an axe, not a scalpel, to accomplish this objective: it "meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices."

Santa Fe, 430 U.S. at 477. Its goal was to outlaw every "device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage." S. REP. NO. 73-1455, at 54.

The majority's decision undermines that goal. It permits schemers who enter into illegitimate transactions that project the mirage of a functioning market to escape liability because they do not personally communicate to investors the illusory pricing information generated by their manipulative acts. Even though investors purchase the securities at prices that they believe are established by the free interplay of supply and demand—but, unbeknownst to them, are the product of a rigged market—they may not recover against the person who engaged in the transaction that created the mirage and profited from it. Such a result is inconsistent with the Exchange Act and should be reexamined by the panel or by the en banc court.

CONCLUSION

The petition for rehearing or rehearing en banc should be granted.

Respectfully submitted,

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June 20, 2013

CERTIFICATE OF SERVICE

I certify that, on June 20, 2013, I filed with the Clerk of the Second Circuit fifteen copies of the Commission's *amicus curiae* brief in support of plaintiffs' petition for rehearing or rehearing en banc, and I further certify that I served two copies of that brief on the following counsel via UPS overnight delivery:

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