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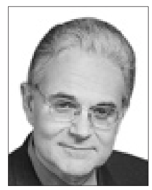
Expert Analysis

Section 10(b)'s 'In Connection With' Requirement Untethered



By **Sarah S. Gold**

And **Richard L. Spinogatti**

The U.S. Supreme Court has long endorsed a broad view of the "in connection with" requirement for civil actions under §10(b) of the Securities Exchange Act to include conduct that "coincides with" securities transactions even where those transactions are not the object of the fraudulent scheme. *SEC v Zandford*, 535 U.S. 813, 822 (2002). We have previously written about the trend to expand *Zandford's* flexible standard to envelop cases seemingly going beyond effecting the remedial purposes of the Exchange Act.[1]

A recent Fourth Circuit case[2] tests the outer boundaries of *Zandford's* flexible standard in the context of an e-mail blast from a publisher of online investor newsletters where neither the author nor publisher traded in the securities at issue nor owed fiduciary duties to its readership. *SEC v. Pirate Investor LLC*, 2009 WL 2949091 (4th Cir. Sept. 15, 2009). Concerned by the lower court's decision, Forbes and other publishers submitted a brief as amici to overturn it. Discarding or stretching most established factors previously used to test the required connection between a fraud and a securities transaction, the U.S. Court of Appeals for the Fourth Circuit affirmed the §10(b) violation here, and dismissed the First Amendment concerns of the amici concluding the speech here was fraudulent speech not entitled to First Amendment protection.

The 'Pirate' Decision

Appellants were Pirate Investor LLC, a company in the business of publishing investment newsletters and sending periodic e-mail "blasts," and Frank Porter Stansberry, editor and author of many Pirate publications. The false statements in *Pirate* related to USEC Inc., a publicly traded company that purchased uranium from a Russian counterpart for use as fuel. Pricing agreements between the companies were subject to approval by the United States and Russia. In February 2002, the companies' new agreement had not yet been approved and both had requested that Presidents George W. Bush and Vladimir Putin place the agreement on the agenda for a summit meeting scheduled for May 23, 2002.

On May 13, 2002, Mr. Stansberry sent an e-mail captioned the "Super Insider Tip E-mail" to a mailing list of subscribers to Pirate newsletters. The e-mail claimed to have information from "a senior company executive" about "a major international agreement" that would be approved on May 22, and informed recipients that the inside information "could make you a lot of money." The e-mail promised that, in exchange for $1,000, the recipient could learn the name of the company. The e-mail was sent to approximately 800,000 subscribers; 1,217 paid the $1,000, and each received a second e-mail titled the "USEC Special Report." The report disclosed the name of the company, provided a financial analysis of its fundamentals, and encouraged purchasers to "call your broker now" and buy shares of USEC.

> 'Pirate' pushed the boundaries of §10(b)'s requirement that fraud be sufficiently connected to securities transactions for liability to attach.

The SEC sued Pirate and Mr. Stansberry under §10(b), alleging they had falsely represented that an insider was the source for the date on which the agreement would be approved.[3] After a bench trial, the district court found that Mr. Stansberry did not have the inside information he touted in the e-mails: he had interviewed a USEC executive, but had not been told the agreement would be approved on May 22.[4] The agreement was approved in June. USEC's stock climbed in price between May 13 and May 22, then declined when no approval was announced on that date. The district court found liability and ordered disgorgement, civil penalties and injunctive relief.

In its per curiam opinion, the Fourth Circuit accepted that the Tip E-mail contained the false statement and intentionally so, since Mr. Stansberry spoke to the executive and thus had to know his statement about that conversation was false. The court also found no clear error in the district court's materiality determination because a reasonable investor would consider it important that the information came from an insider. However, the court focused exclusively on the source of the information and wholly failed to analyze the materiality of the information itself. Apparently, USEC itself had made public that it expected approval in the "near future," and the SEC's former chief economist had testified for appellants that the actual approval date was immaterial; a reasonable investor would only care that USEC foresaw approval soon.[5]

This evidence was not addressed by either court. While the district court also concluded that the stock price rise, which it attributed to the Tip E-mails, supported the materiality of the information, the Fourth Circuit assessed materiality without it, apparently due to substantial evidence in the record that the increase was caused by other factors, including substantial favorable press about USEC and the pricing agreement.[6] The court found that even if the district court should not have attributed the increase to appellants' communications, the stock rise was unnecessary to prove materiality "due to the self-evident materiality of a claim that one possesses inside information."[7]

'Pirate's' Analysis

The most troublesome part of the *Pirate* decision is its conclusion that the misstatement was "in connection with" a securities transaction. The court recognized that saying a fraud violates §10(b) when it "coincides" with a securities transaction "hardly clarifies the matter" and that guidelines are required "to help distinguish between fraud in the securities industry and common law fraud that happens to involve securities."[8] However, the court immediately rejected the requirements developed in prior appellate cases it cited that, to make the necessary connection to securities transactions, appellants had to trade in USEC stock or breach fiduciary duties.[9] Instead, it considered four guidelines, which it considered neither "exclusive" nor "mandatory," stating that "a close fit with one factor may well be enough for a fraud to result in §10(b) liability."[10]

The four factors considered by the court were: (1) whether the securities sale was necessary to completion of the fraudulent scheme; (2) whether the parties' relationship was such that it would necessarily involve trading in securities; (3) whether the defendant intended to induce a securities transaction; and (4) whether

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material misrepresentations were disseminated to the public in a medium on which a reasonable investor would rely. Although *Pirate* proceeded to conclude that all but the second of these factors were met, actually not a single one was met in accordance with prior cases.

Turning to the first factor, the court properly cited cases, including *Zandford*, which found the stock transactions "necessary" because the fraud could not have occurred without them. Nonetheless, *Pirate* found, not that the stock purchases were necessary to complete the fraud, which they plainly were not, but rather that they were necessary to "maximize" the scheme.

Appellants argued that the scheme was sale of the report, resulting in appellants' sole financial gain. To complete that fraud, customers did not need to purchase stock, just the report. Nonetheless, the court concluded that stock purchases were "necessary" because later tip e-mails mentioned the rising stock price which resulted in more sales of the report. Of course, that stock price rise would be relevant to the analysis only if it were caused by the scheme, a conclusion the court in reviewing materiality seemed to acknowledge might not have been supported by the evidence. Nonetheless, the court used the stock price rise to connect the fraud with the securities transactions.

The court also supported its conclusion with the observation that appellants hoped to earn a "reputational gain" from the stock sales leading to future report purchases, a peculiar statement in light of the court's conclusion that appellants had provided knowingly false information to their readership, which obviously would be revealed just days later.

The court then acknowledged that the parties' relationship was not one that necessarily involved trading in securities. "Appellants sold investment advice; ultimately the decision to purchase securities rested squarely with those who received the solicitation and USEC Special Report."[11] However, the court gave no special weight to its acknowledgment that appellants were not in the securities business, owed no fiduciary duties to their readers, and had not traded in USEC securities.

Turning to its third factor, whether appellants intended to induce a securities transaction, the court adopted the lower court's confusing conclusion that "the very essence of the fraudulent scheme was to induce its victims to purchase USEC stock," which appeared in that court's decision shortly after its conclusion that the false statements were made "to induce the recipients to pay $1,000 for the Special Report that completed the intentionally false statements."[12] For its conclusion, the court merely observed that appellants must have intended to induce a securities transaction because there was no other reason to send the report and reiterate the false statement after receiving the $1,000. Apparently, appellants would have been beyond the SEC's grasp if they had simply pocketed the $1,000 and never sent the report, since the Tip E-mail (which withheld USEC's name) could not have induced a securities transaction.

Finally, the court considered reliance: Did appellants utilize a device "that would cause reasonable investors to rely thereon" and "so relying, cause them to purchase or sell a corporation's securities"?[13] The court found that no reasonable investor would rely on either the Tip E-mail or the report, which e-mails the SEC had characterized as SPAM. Despite this unequivocal conclusion, the court, using common law principles, concluded that because appellants targeted a select group of unreasonable investors who relied on Internet investment advice, the reliance requirement was met.

The court acknowledged that the e-mails "have little in common with the types of communication that have heretofore led to liability" and that its decision departs from established law requiring that any such false statements be disseminated in a medium on which a reasonable investor would rely.[14] The court, however, found the essence of the reasonable investor requirement was to protect unwitting speakers from liability for statements that were not directed at investors. That protection was unnecessary here, in the court's view, because appellants targeted this group and could not now object to their reliance. The court apparently believed this analysis to be sufficient despite the lack of any fiduciary duties owed to the appellants' readership.[15]

Apparently recognizing at least one broad implication of discarding the reasonable investor standard, the court dropped a footnote noting (without authority) that the reasonable reliance required to demonstrate "in connection with" was not entirely the same as the "justifiable reliance" required in private civil actions. Apparently, the court was not prepared to bless private §10(b) actions by gullible investors who rely on SPAM for their investment decisions and then seek recovery of their losses.

Amici objected to the unfettered liability of the general press for financial news and analysis resulting from the lower court's decision, noting for example that all publications hope their subscribers will rely upon their financial analyses (including to buy stock) and hope those analyses prove useful and result in more publication sales.[16] Nonetheless, that does not mean that all business analysis that results in the sale of stock is covered by §10(b). Indeed, amici sought to have applied to §10(b) cases the exemption provided in the Investment Advisors Act for publishers of disinterested financial advice, an argument rejected by the Fourth Circuit.[17] Of course, no exemption would be necessary if the court had required that appellants either owe fiduciary duties or have traded in the stock for their misstatements to come within §10(b).

The court in 'Pirate' immediately rejected the requirements developed in prior appellate cases it cited that, to make the necessary connection to securities transactions, appellants had to trade in USEC stock or breach fiduciary duties.

Conclusion

Pirate pushed the boundaries of §10(b)'s requirement that fraud be sufficiently connected to securities transactions for liability to attach. The Fourth Circuit disregarded virtually all the requirements previously understood to anchor the otherwise amorphous "in connection with" standard.

Purveyors of financial analysis and disinterested financial advice will be interested in, if not discomforted by, this decision. But, were other courts to adopt the Fourth Circuit's untethered analysis, there could be no limit to the boundaries of §10(b). *Zandford's* instruction that flexibility is required to effectuate the remedial purposes of §10(b) does not mean there are no limits to the distinction between common law fraud and securities fraud, as the Supreme Court recently reminded us in *Stoneridge*.[18]

1. See Expanding "In Connection With," NYLJ April 14, 2004 at 3, Col. 1, discussing its application in broker cases.
2. The Fourth Circuit is the same court overruled in *Zandford* when it declined to expand the "in connection with" requirement to cover a broker's theft of funds from a discretionary account calling it a common-law conversion which only incidentally involved securities transactions.
3. The SEC also sued Pirate's parent corporation Agora Inc. but the district court found it not liable.
4. *SEC v. Agora Inc.*, C.A. No. MJG-03-1042 (D.Md. Aug 1, 2007).
5. See Brief of Appellants, 2008 WL 360054, at *42-45.
6. *Pirate*, 2009 WL 2949091 at *3-4 n.12.
7. Id.
8. Id. at *6.
9. *SEC v. Savoy Indus.*, 587 F.2d 1149 (D.C. Cir. 1978); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *United Intern. Holdings Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207 (10th Cir. 2000).
10. Id.
11. *Pirate*, 2009 WL 2949091 at *9. The court distinguished this case from that of another Internet investment advice publisher which also offered an "auto-trading" service by which subscribers authorized the online adviser to direct trades in their accounts. *SEC v. Terry's Tips Inc.*, 409 F.Supp.2d 526 (D. Vt. 2006).
12. *Agora*, supra at 24.
13. *In re Carter-Wallace Inc. Sec. Litig.*, 150 F.3d 153, 156 (2d Cir. 1998) (internal quotations omitted).
14. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968); *In re Carter-Wallace Inc. Sec. Litig.*, 150 F.3d 153 (2d Cir. 1998); *SEC v. Rana Research Inc.*, 8 F.3d 1358 (9th Cir. 1993).
15. See, *Basic v. Levinson*, 486 U.S. 224 (1998); *In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.2d 953, 967 (2d Cir. 1993) ("when the fraud alleged is that the plaintiff bought or sold a security in reliance on misrepresentations as to its value, made by a defendant whose position made it reasonable for the plaintiff to rely on the representation and imposed some duty on the defendant to be honest or to disclose information, then whatever problems there may be with the case, a connection between the fraud and the transaction should not be one of them.")
16. See Brief of Amicus Curiae, 2008 WL 2307442.
17. *SEC v. Wall St. Publ. Inst. Inc.*, 664 F.Supp. 554 (D.D.C. 1986) (disinterested publisher defense applicable to §10(b)), rev'd on other grounds, *SEC v. Wall St. Publ. Inst. Inc.*, 851 F.2d 365, 368 (D.C. Cir. 1988). See, *Lowe v. SEC*, 472 U.S. 181, 210 (1985) (defining investment adviser as one who provides personalized investment advice and exempting publisher of publications of "general and regular circulation").
18. *Stoneridge Inv. Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008).