"In Connection with": The Need for Limitation to SEC Rule 10b-5 in Dissemination of Misleading Information Cases

Brendan J. McCarthy

Follow this and additional works at: https://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation
Available at: https://scholarlycommons.law.case.edu/caselrev/vol54/iss4/14

This Note is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.
NOTES

"IN CONNECTION WITH":
THE NEED FOR LIMITATION
TO SEC RULE 10b-5 IN DISSEMINATION OF
MISLEADING INFORMATION CASES

In recent years, securities fraud has become a recurrent topic on the nightly news. Actions based on SEC Rule 10b-5, the preeminent tool of securities law enforcement, have flooded the dockets. Securities fraud is a problem not only for investors, but for businesses as well: the stigma of securities fraud can potentially damage the performance of a firm in both the stock and consumer markets. There is a tension in providing adequate protection to both investors and corporations when a securities fraud action is brought under 10b-5. Courts have encountered 10b-5 claims in a plethora of scenarios and the interpretation of the rule's various elements has not always been clear-cut. One element, the "in connection with" requirement, has received varied interpretation that has led to confusion among courts, investors, and businesses as to when fraud is within the ambit of 10b-5. This Note will examine the "in connection with" requirement in the context of a public misrepresentation by a corporate issuer. It will show that a broad analysis of the requirement is necessary, but that courts should use caution and limit actions against corporations to protect against the stigma of securities fraud associated with frivolous 10b-5 actions.

To analyze the "in connection with" requirement, the origin of the rule first must be addressed. With section 10(b) of the Securities Exchange Act of 1934, Congress gave the SEC power to promulgate rules to prohibit fraud, manipulation, or insider trading.1 With that in mind, the SEC promulgated Rule 10b-5, forbid-

---

1 15 U.S.C. § 78j(b) (2000). In pertinent part, section 10(b) states:

1347
dering the use of manipulative and deceptive devices. To state a claim under SEC Rule 10b-5 a plaintiff must show "(1) fraud or deceit (2) by any person (3) in connection with (4) the purchase or sale (5) of any security." As fraud is a necessary element, the common law elements of fraud must also be shown; that is, scienter, materiality, reliance, causation, and damages must be demonstrated.

Rule 10b-5 has been around for quite some time and has come up in a myriad of factual contexts. In some cases, the connection between the fraud and the sale or purchase of a security has been strained. Professor C. Edward Fletcher described the cases as ranging from paradigmatic securities fraud, his category 1 case, where one party affirmatively induces another to purchase or sell a security, to conversion of stock, his category 6 case, where a person merely intends to deprive an investor of an ownership inter-

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

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

Id. 2

17 C.F.R. § 240.10b-5 (2002). Rule 10b-5 states:

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id. (emphasis added).

3 THOMAS LEE HAZEN, THE LAW OF SECURITIEs REGULATION § 12.4[2] (4th ed. 2002) (drawing on the language of the rule). Compare Scott J. Davis, Liabilities Under Sections 10(b), 18 and 20 of the Securities Exchange Act of 1934, in UNDERSTANDING THE SECURITIES LAWS 835, 847 (PLI Sept.-Dec. 2001) (stating that, in general, an action under 10b-5 requires a plaintiff to prove "(1) a fraudulent or manipulative scheme or a material misrepresentation or omission; (2) the scienter of the defendant; (3) justifiable reliance by the plaintiff; and (4) that the wrongful conduct proximately caused the injury 'in connection with the purchase or sale of a security'.").

4 HAZEN, supra note 3, § 12.4[2].


A misrepresentation by a corporate issuer, where a corporation issues a statement that it knows to be false and on the basis of which investors trade and lose money is his category 2 case. Other factual scenarios that Fletcher illuminated include his category 3 cases where there is a third party connection with the purchase or sale of a security. This would be a situation that involves an investor and a party that is neither the seller or purchaser of a security nor a corporate issuer, but rather an accounting firm or a broker. The category 4 cases involve corporate mismanagement, where plaintiff shareholders try to impose liability against the directors or officers of a corporation, arguing that the stock price was affected by their mismanagement. A fifth category of "in connection with" requirement cases involve misappropriation of information, which is essentially insider trading.

Misleading statements about public securities are troublesome when the speaker is not actually buying or selling securities. The Supreme Court has limited private actions under 10b-5 to actual purchasers or sellers of securities, but courts have had difficulty determining how close the connection must be to satisfy the "in connection with" requirement. Some courts have gone too far, finding a sufficient connection between the fraud and the securities transaction any time material information is disseminated into a medium on which a reasonable investor would rely. Other courts have limited the connection too much in some contexts, requiring the securities' underlying value to be affected. A middle ground is required in order to appropriately capture prohibited conduct within a public misrepresentation context.

In recent years, the federal circuits have divided on how to interpret the "in connection with" requirement. In 2001, the United States Supreme Court declined to review a dangerous precedent in

---

7 Id. at 958.
8 Id. at 932; see also Maloney, supra note 5, at 1180-81 (noting the difference between private misrepresentations and public misrepresentations).
9 Fletcher, supra note 6, at 936-37.
10 Id.
11 Id. at 947.
12 Id. at 954.
13 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); see also Nairobi Holdings Ltd. v. Brown Bros. Harriman & Co., No. 02 Civ. 1230, 2002 WL 31027550, at *4 (S.D.N.Y. Sept. 10, 2002) (stating the general rule that shareholders have no standing to sue when they decide not to sell their shares due to an "unduly rosy representation" or a failure to disclose adverse material) (citation omitted).
15 See, e.g., Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir. 1984); Anatian v. Coutts Bank (Switzerland) Ltd., 193 F.3d 85 (2d Cir. 1999).
which the Third Circuit adopted an extremely broad approach\textsuperscript{17} to the “in connection with” requirement in the context of a public misrepresentation by a corporate issuer. That Circuit held, in \textit{Semerenko v. Cendant Corporation},\textsuperscript{18} that it was unnecessary for the Plaintiff class to establish that the defendants believed the misrepresentations would influence their investment decision. This is dangerous because that is what really connects the misrepresentation to the investment decision.

This Note will argue that in cases involving dissemination of misleading information, 10b-5 is best served by—and investors are sufficiently protected by—using the “in connection with” requirement as a principle of limitation. That is, courts should look to the requirement with an eye toward limiting the number of fraud cases and, thus, protecting corporations from the stigma of securities fraud. This Note will contend that an examination of the broad and narrow approaches to interpretation reveals that the narrow approach (whereby the “in connection with” requirement is satisfied only when the value of the security is affected) is too restrictive in the public misrepresentation context. In addition, this Note will examine federal court decisions that create problems in the interpretation of the “in connection with” requirement, and consequently that \textit{Semerenko} is too broad, encompassing conduct not intended to be prohibited by Congress. To effectuate Congress’s desire that an investor not be induced into a securities transaction by false or misleading information, the test for satisfying the “in connection with” element must require the corporation to have had a reasonable expectation of influencing an investment decision.

I. THE “IN CONNECTION WITH” REQUIREMENT AS A LIMITING PRINCIPLE

Although protection of investors is of the utmost concern under the securities laws, 10b-5 need not be so far reaching as to capture conduct that has a tangential connection to a securities transaction. Rule 10b-5 should be limited in its application to corporate issuers, and the “in connection with” requirement is the appropriate vehicle for accomplishing this. Analysis of the legislative history of section 10(b) of the Securities Exchange Act of 1934, major case law precedent, and recent trends in Congressional legislation indicate the type of activity that should be prohibited under

\textsuperscript{17} \textit{Semerenko}, 223 F.3d at 176.
\textsuperscript{18} 223 F.3d 165.
10b-5. This is conduct that can be expected to influence the investment decision.

A. Legislative History of Section 10(b) of the 1934 Securities Exchange Act

In 1929, security prices escalated to exorbitant levels and, ultimately, the stock market crashed. In response, Congress passed the Securities Exchange Act of 1934 in an attempt to prevent another market failure.\(^{19}\) Rule 10b-5 was later drafted and adopted in a single day to deal with a company president who was buying shares of his company using misrepresentations.\(^{20}\) Focusing on section 10(b) of the 1934 Act is necessary because it gave the SEC authority to promulgate Rule 10b-5. However, legislative history regarding section 10(b) is sparse.\(^{21}\) The only legislative history that even suggested a broad remedial purpose was a comment made by Thomas Corcoran, an advisor to President Roosevelt, who simply noted that section 10(b) was a general catchall provision for manipulative devices.\(^{22}\) However, the “generally understood purpose of the antifraud provisions, including section 10(b), is ‘the encouragement of desirable investment-related behavior by diminishing the fear of fraud and manipulation that might otherwise chill such activity.’”\(^{23}\) It is accepted that, with 10(b), Congress sought to “proscribe fraud, deceit, or manipulation that might compromise either the integrity of investment decisions being made by investors, or the integrity of the market mechanisms that facilitate investment activity.”\(^{24}\) This suggests that protection of investors’ investment activity from manipulation was of prime importance to Congress at the time of enactment.

\(^{19}\) Michael P. Catina & Cindy M. Schmitt, Note, Private Securities Litigation: The Need For Reform, 13 ST. JOHN’S J. LEGAL COMMENT. 295, 296-97 (1998); see also William S. Fein-
stein, Pleading Securities Fraud With Particularity—Federal Rule of Civil Procedure 9(b) in the Rule 10b-5 Context: Kowal v. MCI Communications Corporation, 63 GEO. WASH. L. REV. 851, 852 (1995) (noting that both the 1933 Act and the 1934 Act were direct responses to abuses in the securities markets that precipitated the 1929 stock market crash).

\(^{20}\) Fletcher, supra note 6, at 961.

\(^{21}\) Id.

\(^{22}\) Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong. 115 (1934) (statement of Mr. Thomas Gardiner Corcoran, Counsel with the Reconstruction Finance Corporation).


\(^{24}\) Id.
In *Ernst & Ernst v. Hochfelder*, the Supreme Court traced the history of section 10(b) and deemed significant the following statement by Thomas Corcoran: "The section was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.'" The Court determined that a drafter would not use those words to impose liability for merely negligent acts, and that negligence, therefore, should not be included within the section 10(b) frame. Thus, at a minimum, corporate issuers should be protected from liability for negligently disseminating misleading information.

The Supreme Court's decision in *Hochfelder* also factored in the congressional committee reports regarding section 10(b). The reports indicated that liability would not attach absent scienter, and led to the conclusion that Congress intended no lesser standard for liability under section 10(b). The Senate Report discussed the abuses that gave rise to the need for the 1934 Exchange Act and the inadequacy of self-regulation by the stock exchanges. However, the only reference to section 10 was the statement that:

> In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10, and 16.

As a result, the rule and its elements must be clear.

The issue of a defendant's mindset in a 10b-5 action has largely been addressed by the requirement of scienter. However, it is unclear whether scienter applies simply with respect to the fraudulent act or whether scienter is required with respect to the actual use of the fraudulent act to manipulate an investor's deci-

---

26 *Id.* at 203 (quoting Thomas Corcoran, *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce*, 73d Cong. 115 (1934)).
27 *Id.*
28 *Id.* at 204.
29 *Id.* at 204-05 (quoting S. REP. No. 73-792, at 6 (1934)). It should be noted that the Senate Report gave a summary of S. 3420, 73d Cong. (1934) by sections, and with respect to section 10(b) it stated that it authorized the Commission to prohibit or regulate the use of "any other manipulative or deceptive practices." S. REP. No. 73-792, at 18 (1934). False information was included in this category earlier in the report. S. REP. No. 73-792, at 8 (1934).
30 See Davis, *supra* note 3, at 393 (noting that "[s]ince Ernst & Ernst, all circuits except the Fourth have adopted the view that recklessness is a sufficient basis for liability under Rule 10b-5" with respect to scienter).
If it is with respect to the act, then it appears that any fraud with a tangential connection to securities in a transaction could result in 10b-5 liability. This is not what Congress intended. Although the SEC was given "discretionary and elastic" powers, Congress was concerned with protecting investment activity, not with making common law fraud actionable under the securities laws. If, however, a defendant must have scienter with respect to manipulating an investor's decision, then there is a link between the manipulative conduct and the investment activity. Either way, to protect the integrity of investment activity, a connection between the fraud and the transaction itself must be required.

B. Analysis of Major Precedent in 10b-5 Cases

The "in connection with" requirement was first analyzed in 1952 in *Birnbaum v. Newport Steel Corp.* The Second Circuit suggested that, for the requirement to be met, the deception or manipulation must be something that is "usually associated" with the sale or purchase of a security. Professor Fletcher believed that this early approach may have been an attempt both to limit the application of 10b-5, such that it would conform with the purposes for which it was designed, and to define the instances in which the "in connection with" element would be satisfied.

The next major case on the "in connection with" requirement was *SEC v. Texas Gulf Sulphur Co.* The Texas Gulf Sulphur Company ("TGS") discovered minerals on its Canadian property. Before the information was released to the public, company officials purchased shares of its stock on the open market. Additionally, the board issued stock options to key management personnel who were aware of the discovery. A press release was then issued to deny rumors in Canada that TGS had a major ore strike in

---

31 See Fletcher, supra note 6, at 919 (noting that the deception or fraud must have been made with scienter to satisfy the fraud element); 2 HAZEN, supra note 3, § 12.4(2) (noting that "[i]n its strictest sense, scienter means intent to deceive"); see also In re Navarre Corp. Sec. Litig., 299 F.3d 735, 742 (8th Cir. 2002) (noting that scienter means the intent to deceive, manipulate, or defraud); In re NationsMart Corp. Sec. Litig., 130 F.3d 309, 320 (8th Cir. 1997) (same).
32 193 F.2d 461 (2d Cir. 1952).
33 Id. at 464; see also Muratori, supra note 23, at 1059 (discussing the suggestion by the court).
34 Fletcher, supra note 6, at 922-23; see also Comment, *Private Enforcement Under Rule 10b-5: An Injunction for a Corporate Issuer?*, 115 U. Pa. L. Rev. 618, 620 (1967) (discussing Birnbaum and stating that it judicially imposed a limit on the use of 10b-5 in private actions).
35 401 F.2d 833 (2d Cir. 1968).
37 Id.
the making. Several days later, TGS announced the extent and significance of the finding, and the price of its stock rose substantially. The SEC brought a suit under 10b-5.

With respect to whether the misrepresentation (here, the false press release) was sufficiently connected to the purchase or sale of a security, the Second Circuit first looked to the legislative history of section 10(b) and noted that:

The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading, including, specifically, inequities that follow from trading that has been stimulated by the publication of false or misleading corporate information releases.

In this case, which directly dealt with misleading statements by a corporate issuer, the court held that the “in connection with” requirement is satisfied whenever assertions are made in a manner “reasonably calculated to influence the investing public... if such assertions are false or misleading or are so incomplete as to mislead.”

The court could not conclude from the record that the press release was misleading to the reasonable investor and so the case was remanded.

This “reasonably calculated” language indicates that a corporation should not be held liable for misrepresentations unless a corporation has an expectation that an investor’s investment decision will be manipulated. This is certainly an attempt to limit actions against corporate issuers to those that Congress envisioned at the time of the 1934 Act. If a misrepresentation is not calculated to influence an investment decision, there seems to be no need to protect the investment activity because any harm would be incidental. Of course, an argument can be made that any time a misrepresentation has the effect of influencing the investment decision the issuer should be held liable. However, in looking for a link

38 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 845-46 (2d Cir. 1968); see also Comment, Liability Under Rule 10b-5 for Negligently Misleading Corporate Releases: A Proposal for the Apportionment of Losses, 122 U. Pa. L. Rev. 162, 164-65 (1973) (noting that two major New York newspapers had reported the rumors of a strike while the press release issued by TGS reported that the findings were valueless, and held a pessimistic view of the explorations, but subsequently TGS reported a strike of at least 25 million tons of ore).

39 Fleischer, supra note 36, at 1273.

40 Id.

41 Texas Gulf Sulphur, 401 F.2d at 858.

42 Id. at 862.

43 Id. at 862-63.

44 Such an argument would, however, be based on a causation analysis, which is already a
between the misrepresentation and the transaction, whether something actually influenced an investment decision is an issue of causation, not connection. The United States Supreme Court weighed in on the “in connection with” requirement in Superintendent of Insurance v. Bankers Life and Casualty Co., though the decision does not deal with public misrepresentations by corporate issuers. In this case, Manhattan Casualty Company, represented by the superintendent, was defrauded in the sale of securities. Bankers Life and Casualty Company had agreed to sell all of Manhattan’s stock for five million to an individual who conspired with another individual to pay for the stock with Manhattan’s assets, rather than with their own funds. They had arranged, through a brokerage firm, to obtain the money from a trust company with which they had no funds on deposit. They then purchased the stock from Bankers Life and sold Manhattan’s corporate treasury bonds to credit against the five million dollars, thus using Manhattan’s assets to purchase the stock.

The Supreme Court found that, as the seller of treasury bonds, Manhattan was protected by section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5. The Court further stated that “Section 10(b) must be read flexibly, not technically and restrictively.” It held that Manhattan had stated a cause of action because the “crux of the ... case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor.” Subsequent decisions in the federal circuits grasped this “touching” language and held the “in connection with” requirement satisfied whenever the fraud touched the transaction—not a high standard. The scope of the opinion in Bankers Life

part of a 10b-5 action and does not go to the issue of connection.

45 See Muratori, supra note 23, at 1061 (discussing an approach of causation in the “in connection with” requirement analysis as being troubling to both scholars and courts because there is a separate element of causation and that such “but for” causation should not be enough to trigger liability).
47 Id. at 7.
48 Id.
49 Id. at 8.
50 Id.
51 Id. at 9.
52 Id. at 12.
53 Id. at 12-13.
54 See Bruce G. Vanyo & Terry T. Johnson, Restrictions on the Scope of the Civil Liability Provisions of the Federal Securities Laws, in SECURITIES LITIGATION 1986: PROSECUTION AND DEFENSE STRATEGIES 255, 317 (PLI Sept. 1986) (discussing Bankers Life, and stating that until 1975 the Supreme Court took an expansive view of the securities laws believing that the laws had to be construed flexibly to effectuate the remedial purpose intended by Congress); Lewis D.
was potentially limitless,\textsuperscript{55} eliminating a principal means of caging the broad antifraud provision that is 10b-5.\textsuperscript{56}

Four years later, the Supreme Court limited private actions under 10b-5. In \textit{Blue Chip Stamps v. Manor Drug Stores},\textsuperscript{57} the Court held that offerees who declined to purchase securities under a court-ordered offering, due to a pessimistically false and misleading prospectus, could not sue under 10b-5 because they were not actual purchasers or sellers of securities.\textsuperscript{58} These facts conform more closely to the scenario of a public misrepresentation by a corporate issuer and provide evidence of an effort to limit actions under 10b-5. This limitation comes through the use of the “purchaser or seller” element. As the SEC does not need to be a purchaser or seller of securities to bring suit, the “in connection with” requirement could serve as a limit to its actions. Though conferred with “discretionary and elastic” powers, the SEC should not go unchecked. The counterargument is that protection of investors requires that the SEC not be limited in its actions against corporate issuers.\textsuperscript{59} On balance, it seems that placing a limit on the SEC’s ability to pursue actions against corporations, by confining the “in connection with” requirement, would not be a heavy restraint on its power.

Now, we must consider the present. In the 2002 decision of \textit{SEC v. Zandford},\textsuperscript{60} the issue facing the court was whether a securi-

\textsuperscript{55} Lowenfels & Alan R. Bromberg, \textit{Rule 10b-5’s “In Connection With”: A Nexus for Securities Fraud}, 57 BUS. LAW. 1, 8 (2001) (noting that use of the word “touching” is all encompassing and has been widely cited, giving the example of \textit{United States v. Russo}, 74 F.3d 1383 (2d Cir. 1996), where the court relied on the language to sustain fraud convictions of brokerage firm executives).


\textsuperscript{57} 421 U.S. 723 (1975).

\textsuperscript{58} Lowenfels & Bromberg, supra note 54, at 9 (summarizing the Court’s holding, citing \textit{Blue Chip}, 421 U.S. at 726-727, 755).

\textsuperscript{59} See Charles T. Williams, III, Comment, Semerenko v. Cendant Corp.: \textit{Has the Time Come to Prune the “Judicial Oak”?}, 27 DEL. J. CORP. L. 587, 609-10 (2002) (arguing that in some situations where there is a high proximity between the misrepresentation and the corporation’s own securities courts should use the relaxed materiality and dissemination standard in analyzing the “in connection with” requirement, and that to require more would “frustrate the enforcement power of the SEC and place a potentially insurmountable burden on Rule 10b-5 private plaintiffs with valid claims”).

\textsuperscript{60} 122 S. Ct. 1899 (2002).
ties broker’s fraudulent conduct was “in connection with” the purchase or sale of a security. Although this case involved a third-party broker, it is the latest interpretation of the “in connection with” requirement by the Court. The defendant broker therein convinced an elderly man to open a $419,255 joint investment account and to grant the broker discretion to manage it. On twenty-five occasions, money was transferred from the elderly man’s account to accounts controlled by the defendant. The SEC sued under 1Ob-5.

The Court said that the purpose of the Securities Exchange Act of 1934 was “to insure honest securities markets and thereby promote investor confidence.” The Court added that the statute must not be construed so flexibly as to convert into a violation of section 10(b) every case of common law fraud that happens to involve a security. The Court even noted that the SEC and the Court have never held that there must be a misrepresentation as to the value of a security in order for conduct to be a violation of the Act. The defendant was found to be in violation because the investor was injured due to the deception’s depriving him of any compensation for the sale of his valuable securities. This decision demonstrates that the SEC and the Supreme Court have not—and do not—endorse a narrow approach to the “in connection with” requirement. It also indicates that common law or commercial fraud is not within the scope of 10b-5. Although the decision does not deal with a public misrepresentation by a corporate issuer, it suggests both that courts should proceed with caution in analyzing the “in connection with” requirement and that corporations should be protected when the misrepresentation does not influence an investment decision.

C. Trends in Securities Laws

Trends in securities legislation show that corporations have been increasingly afforded more protection. Congress began fo-
focusing on securities litigation reform toward the end of 1991 as corporate issuers argued that a broader, better defined safe harbor was needed because companies that voluntarily disclosed forward-looking statements were exposed to a dramatically increased risk of securities fraud class actions. Corporate issuers believed that existing safe harbor provisions were inadequate because courts did not apply them consistently. Surveys suggested that the threat of mass shareholder litigation, whether real or perceived, deterred the voluntary disclosure of forward-looking statements.

In 1995, Congress passed the Private Securities Litigation Reform Act ("Reform Act") to "protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." The Reform Act amended the Securities Exchange Act of 1934 in two principal ways. First, it provided a safe harbor for specific forward-looking statements in order to encourage corporations to disclose information about future prospects without the fear of frivolous litigation. Second, it changed several requirements for private claim litigation under the federal securities laws.

The statutory safe harbor provision was intended to encourage the voluntary disclosure of forward-looking statements by providing a procedure for the summary disposition of claims that were based on allegedly false or misleading predictive statements. Although the safe harbor applies only to private claims, it evidences the intent of Congress to afford corporations more protection from damaging lawsuits, but at the same time protect investors by encouraging corporate disclosure. Forward-looking statements receive protection when they are identified as such and are accompanied by cautionary statements that identify factors that could cause actual results to differ materially from those stated. Even if cautionary statements do not accompany a forward-looking

---

71 Id.
72 Id.
75 Davis, supra note 3, at 409-10.
76 Id.
77 Parker, supra note 70, at 271.
statement, a 10b-5 plaintiff must prove that the statement was made with actual knowledge that it was false or misleading. This safe harbor provision arguably is sufficient protection for corporations that are fearful their statements may later turn out to be false and, thus, form the basis of a 10b-5 action. However, though the safe harbor provision applies only to private claims, the SEC may wield its “discretionary and elastic” power and bring a suit when the corporation otherwise believed that it was protected. Thus, a limitation using the “in connection with” requirement is necessary.

The Reform Act provided for a heightened pleading standard that requires dismissal of complaints that are not specific enough with respect to an allegedly misleading statement or with respect to a defendant’s state of mind. The Securities Exchange Act of 1934 now requires that complaints alleging securities fraud “specify each statement alleged to have been misleading, the reason or reasons why the statement or omission is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all the facts on which that belief is formed.” Thus, plaintiffs must have adequate facts upon which to base their claims before proceeding with litigation. While this legislation offers further protection to corporations, it does not necessarily protect against a plaintiff’s bringing an action based on commercial or common law fraud and linking it to a securities transaction. This renders the “in connection with” requirement crucial for limiting actionable conduct to that which is clearly a prohibited manipulation: it can effectively bar plaintiffs who would otherwise succeed, despite having alleged an inadequate nexus, because the heightened pleading is only an obstacle as far as particularity in pleading is concerned.

Another example of the congressional movement toward more protection for corporate issuers is the Securities Litigation Uniform Standards Act of 1998. It became apparent to Congress that the purpose of the Reform Act was being frustrated because plaintiffs were evading the heightened pleading requirements by suing

---

81 Id. at 412.
83 See Nathenson v. Zonagen, Inc., 267 F.3d 400, 407 (5th Cir. 2001) (noting that a 10b-5 plaintiff must plead specific facts giving rise to a strong inference of scienter, and that motive and opportunity are insufficient).
in state court rather than federal court.\textsuperscript{85} The purpose of the Uniform Standards Act is to preempt actions in state courts based upon alleged securities fraud, and is achieved by the Act’s focusing specifically on regulating class actions.\textsuperscript{86} Thus, with few exceptions, federal court is the sole avenue for securities fraud class actions,\textsuperscript{87} and the heightened pleading standards of the Reform Act apply. This is strong evidence that corporations are to be given greater protection under the securities laws. Although this legislation is helpful in protecting corporations from frivolous class actions, it does not protect against individual actions by investors.\textsuperscript{88} There is also the problem of the inadequacy of the pleading requirement. One could argue that these individual actions involve less money and are, therefore, something that corporations do not need protection from. However, due to the public relations nightmare that could result from a securities fraud action, corporations should at least have protection from those individual actions that are frivolous.

The most recent legislation in securities law is the Sarbanes-Oxley Act of 2002.\textsuperscript{89} Sarbanes-Oxley was Congress’ response to the financial collapses of Enron, WorldCom, and Global Cross-

\textsuperscript{85} Behlen v. Merrill Lynch, 311 F.3d 1087, 1091 (11th Cir. 2002); see also SEC Commissioner Wallman Sees Need for Uniform Standards Law, 29 Sec. Reg. & L. Rep. (BNA) 1259, 1259 (Sept. 12, 1997) (reporting that SEC Commissioner Wallman believed that it did not make sense to expect corporations to disclose information that would be protected at the federal level, but would still subject them to state law claims); Litigation Reform: Congress Targets "Loophole" in 1995 Act Barring Vexatious Suits, 29 Sec. Reg. & L. Rep. (BNA) 1211, 1211 (Aug. 29, 1997) (noting that before the Reform Act was a year old, plaintiffs’ attorneys were doing "an end run" around it by suing in state court). It should be noted that a party seeking to remove an action to federal court under the Securities Litigation Uniform Standards Act has the burden of proving that (1) the suit is a covered class action; (2) the plaintiff’s claims are state law based; (3) one or more covered securities have been purchased or sold; and (4) the defendant misrepresented or omitted a material fact in connection with the purchase or sale of the security. Behlen, 311 F.3d at 1092 (quoting Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 292 F.3d 1334, 1342 (11th Cir. 2002)).

\textsuperscript{86} Catina & Schmitt, supra note 19, at 311-12.

\textsuperscript{87} Behlen, 311 F.3d at 1091-92 (also noting that Congress further mandated that the class actions would be governed by federal securities law and not state law) (citing H.R. Conf. Rep. No. 105-803, at 13 (1997)).

\textsuperscript{88} Congress did attempt to fill the gap left by the Reform Act with the Securities Litigation Improvement Act of 1997. H.R. 1653, 105th Cong. (1997). It would have created uniform pleading standards for individual shareholders that allege securities fraud with respect to federally regulated securities in actions brought in state court. See Catina & Schmitt, supra note 19, at 311 (describing the bill as a response to strike suits brought in state courts). The bill, however, failed to pass. See Richard W. Painter, Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action, 84 CORNELL L. REV. 1, 2 n.2 (1998) (noting that the bill did not proceed further than the House of Representatives).

ing. This Act attempts to improve investor protection and reinforce the securities laws. The five major components to the Act are "(1) new requirements for audit committees and auditors, including restrictions on non-audit services; (2) new corporate governance standards for directors and executive officers; (3) extended company disclosures; (4) increased enforcement and penalty schemes; and (5) mandated special studies." This is not necessarily a shift in securities legislation trends toward more protection for investors because, in large part, Sarbanes-Oxley simply supplements and fills loopholes in previous securities laws. As such, it should not be construed as opening up the floodgates for 10b-5 liability. As courts will undoubtedly be flooded with securities law actions based on public misrepresentations by corporate issuers, it is now a critical time to strike the balance between protection of investors and protection of corporations, and to limit 10b-5 actions.

Given these trends in the past ten years, it appears that Congress has moved in the direction of affording corporations more protection. The attempt to rein in actions under 10b-5 is evident, and courts should try to limit frivolous actions. The "in connection with" requirement is just the device to limit frivolous 10b-5 claims since it is the link between the fraud and the securities transaction: there is nothing more frivolous than an action based upon a misrepresentation having a merely tangential connection to securities or a transaction involving securities. If there is ambiguity in a 10b-5 action, it is with respect to how close the fraud has to be to the transaction. Courts should adopt a test that eliminates the ambiguity by requiring a corporation to have had a reasonable expectation of influencing an investment decision in order for the "in connection with" requirement to be satisfied.

---

90 See Jenny B. Davis, Sorting Out Sarbanes-Oxley: Determining How to Comply with the New Federal Disclosure Law for Corporations Won't Be Easy, 89 A.B.A. J. 44, 45 (Feb. 2003) ("In its essence, the Sarbanes-Oxley Act of 2002 is about disclosure. Crafted by Congress in the aftermath of financial collapses at corporations like Enron, Global Crossing, and WorldCom, the new law establishes the framework for a new regime of accountability by public companies in the areas of financial reporting and disclosure, audits, conflicts of interest and governance.").


92 Id. It has been noted that "emerging empirical research suggests that many factors other than fraud are accountable for the market's rise and fall at the end of the millennium," Joseph A. Grundfest, Punctuated Equilibria in the Evolution of the United States Securities Regulation, 8 Stan. J.L. Bus. & Fin. 1, 3 (2002) (also noting that it has been demonstrated that the price declines in U.S. equity markets are comparable to those in other countries that have not experienced high-profile accounting and governance scandals).

93 See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 691 (2d ed. 1997) (noting that a person could take the "delimiting statutory language as an expression of intent to restrict the coverage of the antifraud
II. DISPARATE CIRCUIT INTERPRETATIONS OF THE “IN CONNECTION WITH” REQUIREMENT

There are inconsistent standards for the “in connection with” requirement between the circuits and even within them. The approach adopted by a circuit may apply regardless of the factual scenario, though the test is normally highly fact specific. This Part looks at some of the approaches taken and inquires how an approach would work in a case of public dissemination of misleading information by a corporate issuer. A balance between protection of investors and corporations must be sought, as well as recognition that the connection is more attenuated than the paradigmatic securities fraud case.

A. The Broad and Narrow Approaches

1. A Broad Approach May Not Be Sufficient

Lewis D. Lowenfels and Alan R. Bromberg have identified several circuits that have adopted a broad construction of the “in connection with” requirement. The Second Circuit follows a broad approach, as illustrated by Press v. Chemical Investment Services Corp. In Press, the purchaser of a corporate treasury bill alleged that Chemical did not disclose that the funds at maturity would not be immediately available, so the period over which the yield should have been calculated was longer than the investment company represented. This was done, Press claimed, so
that Chemical would have more time to use the funds. He thus had to pay an additional fee to get the funds four calendar days after the maturity date.\footnote{Id.} The district court held that the plaintiff’s claim that he was improperly denied prompt access to the funds from his treasury bill failed, because the misrepresentation was not related directly enough to the security’s value to satisfy the “in connection with” requirement. The Second Circuit rejected this reasoning.\footnote{Id. at 537.} It stated that the district court confused the materiality analysis with the “in connection with” analysis in finding that the yield availability date did not pertain to the security itself or its value.\footnote{Id.} The Second Circuit noted that it had interpreted the “in connection with” requirement broadly so that the act complained of need only have somehow induced the purchaser to make the purchase.\footnote{Id. (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-61 (2d Cir. 1968)).} Therefore, the alleged yield delay was “in connection with” the sale of a security and, if there was an issue, it was an issue of materiality.\footnote{Id.}

The Seventh Circuit has also adopted a broad approach. \textit{SEC v. Jakubowski},\footnote{Id. at 675 (7th Cir. 1998).} is a case in which the defendant, an attorney, lined up stock from savings associations that were abandoning the mutual form.\footnote{Id. at 677.} Historically, managers took advantage of this and issued stock at a low price so that they can appropriate the net worth of the company for themselves.\footnote{Id.} The SEC passed several regulations to limit managers’ ability to line up stock.\footnote{Id. at 678.} The president of Generation Capital Associates (“GCA”), a venture capital firm, contacted Jakubowski to tell him that Cragin Federal Bank for Savings was converting from mutual to stock form, and asked the attorney to find a depositor who was eligible to purchase stock.\footnote{Id. (citing 12 C.F.R. § 563b.3, which limits managers’ ability to invest when a mutual converts to stock form and gives each account holder a right to purchase some of the stock, and 12 C.F.R. § 563b.3(i), which prevents managers from buying the account holders’ for a meager amount by making the rights non-transferable).} The president of GCA offered to supply the capital nec-
necessary to buy as much stock as possible, and to pay Jakubowski 3.5% of any profit. The stock, however, had to be lined up before it was issued because afterward the initial buyers could just sell to the market.\(^\text{111}\) The attorney found a secretary at his law firm who was eligible to purchase the stock, and she agreed to let Jakubowski use her subscription rights.\(^\text{112}\) Cragin issued the stock to the secretary, but never saw the document that assigned ownership of the stock to GCA and the contract that awarded to the secretary 6.75% of any profit that GCA would obtain through the subsequent sale of the stock.\(^\text{113}\) GCA sold the stock and paid both the secretary and the defendant as promised. The defendant subsequently engaged in a series of similar transactions.\(^\text{114}\) The SEC sued, alleging that the attorney violated Rule 10b-5 because the stock purchase forms, which Jakubowski completed, falsely stated that the stock was being purchased by the secretary, when in fact GCA was purchasing it.\(^\text{115}\)

The court noted that the defendant made his statements directly to the issuer of the securities (Cragin) in order to induce the sale.\(^\text{116}\) Since Jakubowski represented himself as a purchaser (by signing the stock purchase form along with the secretary) and Cragin was selling the securities, the court stated that the "in connection with" requirement was met.\(^\text{117}\) Noting that "a misrepresentation can be 'in connection with' the purchase or sale of securities only if it influences an investment decision,"\(^\text{118}\) the court found that Jakubowski and the president of GCA made investment decisions when they purchased stock issued by the converting S&Ls, because they intended to sell the securities purchased to make a profit.\(^\text{119}\)

Although the purchasers in Jakubowski (GCA, the secretary, and the defendant) were defrauding the seller (Cragin),\(^\text{120}\) the reasoning of the case can translate to a situation where a misrepresentation is made by neither a purchaser nor a seller, but by a corporate issuer. The court stated that requiring an investment decision

\(^{111}\) Id.
\(^{112}\) Id.
\(^{113}\) Id.
\(^{114}\) Id.
\(^{115}\) Id.
\(^{116}\) Id. at 679.
\(^{117}\) Id.
\(^{118}\) Id. at 680 (citing Isquith v. Caremark International, Inc., 136 F.3d 531, 534-36 (7th Cir. 1998); LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931-32 (7th Cir. 1988); Harris Trust & Savings Bank v. Ellis, 810 F.2d 700, 704 (7th Cir. 1987)).
\(^{119}\) Id.
\(^{120}\) This is paradigmatic securities fraud where the connection is apparent, in that the purchaser is directly defrauding the seller of the securities. Fletcher, supra note 6, at 929-30.
to be affected by the misrepresentation is consistent with the Supreme Court’s holding in *Santa Fe Industries, Inc. v. Green* that “corporate mismanagement and [other] similar wrongs do not violate 10b-5 even though they may affect the price at which securities trade.” The Seventh Circuit’s observation that acts may affect the value of a security, yet not violate 10b-5 under *Santa Fe*, is evidence that a narrow approach would not capture conduct intended to be prohibited. This case, by adopting a broad approach, indicates that limitation of corporate liability through the use of the “in connection with” requirement is possible, if not desirable. It would seem that such limitation in public misrepresentation cases would be desirable as well, since the connection is more attenuated than in paradigmatic securities fraud. To require the security itself to be affected ignores the fact that the one who was wronged was not the security, but the one making the investment decision.

The Tenth Circuit adopted a broad approach in *United International Holdings, Inc. v. Wharf (Holdings) Limited*, which involved an operator of cable television systems, United International Holdings (“UIH”), suing Wharf, which obtained a license to operate a cable television system in Hong Kong. UIH asserted that it had provided services to Wharf that enabled it to obtain a cable license and to implement the system. UIH further claimed that it had an option to buy ten percent of the cable system as compensation and that Wharf misled it and never intended to honor the option. One claim for relief was based on 10b-5. The sale of the option was admitted by Wharf to be a sale of a security, so the issue was whether the misrepresentations were “in connection with” the purchase or sale of a security. The court found that the misrepresentations were allegedly made to induce UIH’s investment decision to purchase the option.

---

122 Id. at 680.
123 210 F.3d 1207 (10th Cir. 2000).
124 Id. at 1214.
125 Id. at 1219.
126 Id.
127 Id. at 1221.
128 Id. The U.S. Supreme Court affirmed the decision by the Tenth Circuit. *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001). It was noted that “[e]ven were it the case that the Act covers only misrepresentations likely to affect the value of securities, Wharf’s secret reservation was such a misrepresentation. To sell an option while secretly intending not to permit the option’s exercise is misleading, because a buyer normally presumes good faith.” Id. at 589.
2. The Narrow Approach Does Not Capture Prohibited Conduct

Some courts have taken a narrow view of Rule 10b-5's "in connection with" requirement, generally by insisting that the misrepresentations affect the price or value of the security. The principal case adopting this approach is Chemical Bank v. Arthur Andersen & Co.

In Chemical Bank, three actions were brought by four banks that had made loans to Frigitemp Corp. and its wholly owned subsidiary, Elsters, Inc. Frigitemp sought to expand and acquire other companies, but it needed large amounts of capital and, consequently, a restructuring of its debt. In order to restructure its debt, Frigitemp engaged in a series of transactions resulting in $15.5 million in debt. One transaction was a $4 million advance, for which Frigitemp pledged 100% of Elsters' common stock, pursuant to a pledge and security agreement. About one year later, after Frigitemp had paid approximately $4 million to the banks, it filed for bankruptcy and the banks sued. The banks argued that Arthur Andersen & Co., an accounting firm, and three principal officers of Frigitemp had violated 10b-5 on the basis that they knew that Frigitemp's financial statements were false and misleading. Andersen argued that, even if it had made a materially false statement or had omitted to state a material fact, the statement or omission was not "in connection with" the banks' purchase or Frigitemp's sale of the Elsters stock by way of the pledge to secure the $4 million loan made to Elsters.

The Second Circuit, while deciding that the pledge of stock was a sale of a security, concluded that the misrepresentation was not "in connection with" the stock's sale or purchase. The court reasoned that the purpose of Rule 10b-5 is:

to protect persons who are deceived in securities transactions— to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the

---

129 See Lowenfels & Bromberg, supra note 54, at 21 (describing specific situations in which courts have taken a narrow view of Rule 10b-5).
130 726 F.2d 930 (2d Cir. 1984).
131 Id.
132 Id. at 931.
133 Id. at 932.
134 Id. at 933.
135 Id.
136 Id. at 933-34.
137 Id. at 941.
138 Id. at 945.
buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.\(^{139}\)

According to the court, the banks got exactly what they expected, as the misrepresentation was with respect to the financial description of Frigitemp, not the Elsters stock.\(^{140}\)

Another Second Circuit case following a narrow approach to the “in connection with” requirement is *Anatian v. Coutts Bank (Switzerland) Ltd.*\(^{141}\) The plaintiffs in this case were Rachamin Anatian, seven limited liability companies that he controlled, and Mordechai and Margaret Gal-Oliver.\(^{142}\) Anatian became a client of Coutts Bank, borrowing $3.7 million, and securing it with shares of stock he owned in USA Detergents. Anatian founded and became the principal shareholder of Global Shopping Network (“GSN”), and Global Broadcasting System (“GBS”).\(^{143}\) The plaintiffs claimed that between 1995 and 1997, Coutts representatives fraudulently induced Anatian to borrow $100 million to purchase TV stations and supply the private equity element for the initial public offering of GSN.\(^{144}\) Coutts representatives additionally persuaded Anatian to create seven limited liability companies to which the bank could loan money for Anatian’s benefit, while at the same time circumventing the internal and legal per-borrower lending limits.\(^{145}\) The Coutts representatives assured Anatian that the arrangement would satisfy its internal lending regulations and that the New York office had the authority to make loans without the approval of any other Coutts office.\(^{146}\) The Gal-Olivers also claimed that Coutts representatives convinced them to borrow $2 million, half being retained in a Coutts certificate of deposit, and half being used by the Gal-Olivers to purchase GSN stock.\(^{147}\) Anatian pledged his stock in USA Detergents as collateral for his loan and arranged for the limited liability companies to pledge GSN stock as collateral for the loans. The plaintiffs alleged that Coutts falsely inflated the value of the GSN stock in order to extend more credit to them.\(^{148}\) After loaning all this money, the

---

\(^{139}\) *Id.* at 943.

\(^{140}\) *Id.* The court went on to state that “it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of a security is a part.” *Id.*

\(^{141}\) 193 F.3d 85 (2d Cir. 1999).

\(^{142}\) *Id.* at 86.

\(^{143}\) *Id.* at 87.

\(^{144}\) *Id.*

\(^{145}\) *Id.*

\(^{146}\) *Id.*

\(^{147}\) *Id.*

\(^{148}\) *Id.*
Coutts representatives reneged on the loan commitment. Without further credit, there could be no public offering, and GSN was forced to declare bankruptcy.

Coutts initially sued the plaintiffs for defaulting on over $40 million in loan obligations. In response, the plaintiffs brought action under section 10(b) of the 1934 Securities Exchange Act. The court found that the "plaintiffs' claim that Coutts deceived them by inflating the value of GSN stock in order to extend them more credit falls short of the mark. It is not sufficient to allege fraud in a transaction in which a security is a part."

3. A Balanced Approach Is Necessary

A balance between protection of investors and corporations must be sought, as well as recognition that the connection is more attenuated than the paradigmatic securities fraud case. An approach requiring a reasonable expectation of influencing an investment decision best serves this purpose. Expectation provides the link between the misrepresentation and the securities transaction. A corporation could, for example, make a public statement that it desires its financial situation to improve in the near future. Such a statement could be pure optimism, and not reasonably expected to influence an investor into purchasing or selling a security, though the corporation knows that its financial situation is likely to remain stable. Once the corporation can reasonably expect that an investor's decision to buy or sell a security will be influenced by its misrepresentation, it has crossed the line and has made itself part of the transaction.

---

149 Id. The Coutts representatives claimed that the home office put an end to the arrangement. Id.

150 Id.


152 Anatian, 193 F.3d at 87.

153 Id. at 88 (citing Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984)).

154 See Suna v. Bailey Corp., 107 F.3d 64, 70 (1st Cir. 1997) (noting statements that convey the company's desire for profitable performance in the future that do not contain promises about future performances and do not contain specific numbers should not be actionable because no reasonable investor would rely on those statements); see also Nathenson v. Zonagen Inc., 267 F.3d 400, 419 (5th Cir. 2001) (noting that generalized positive statements about a company's progress and puffery are not bases for liability under the securities laws); Nairobi Holdings Ltd. v. Brown Bros. Harriman & Co., No. 02 Civ. 1230, 2002 WL 31027550, at *7 (S.D.N.Y. Sept. 10, 2002); In re Lucent Technologies, Inc. Sec. Litig., No. 00-CV-621, 2002 WL 1396852, at *14 (D.N.J. June 26, 2002). But see Hanon v. Dataproducts Corp., 976 F.2d 497, 501 (9th Cir. 1992) (noting that projections and general expressions of optimism may be actionable under the securities laws).
The broad approach is generally sufficient. Although *Press* is a category 3 case involving a third-party broker, it is closely connected to the category 2 cases in which there is a misrepresentation by a corporate issuer. Thus, the reasoning in *Press* can be used in cases where there has been a public misrepresentation by a corporate issuer on a matter not directly related to the actual transaction. As noted by the court, "[t]angential misrepresentations about a security are insufficient to support a claim under Section 10(b)." The test here ensures that conduct that in no way influences a party’s decision to purchase or sell a security does not lead to 10b-5 liability. It would seem that if tangential misrepresentations about a security should not result in liability under 10b-5, then tangential misrepresentations that are made public and do not influence an investment decision should similarly evade liability.

However, the broad approach may not work well if implemented incorrectly. The court in *United International Holdings* adopted the “intent to influence an investment decision” test and found that the plaintiff could state a claim under 10b-5. To protect the investment decision, which, in that case, was providing services in exchange for the right to purchase an option, liability should attach. The misrepresentation did not affect the underlying value of the security, but it did lead the plaintiff to expend substantial time, effort, and money in order to get the cable system up and running. The problem with the broad approach here is not that it fails to establish a connection between the misrepresentation and the transaction, but rather that the word “intent” may be too limiting in a public misrepresentation context. A “reasonable expectation” test can establish a connection with a lesser standard.

Therefore, a broad approach to the interpretation of the “in connection with” requirement is necessary in order to strike a balance between protection of investors and protection of corpora-

---

155 Here the closeness is even more evident as the broker had a responsibility to the investor resembling that of a corporation, which a different type of third party, namely an accounting firm, would not have.

156 *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 537 (2d Cir. 1999).

157 *United Int’l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1221 (10th Cir. 2000) (citing SEC v. Jakubowski, 150 F.3d 675, 679 (7th Cir. 1998) and Angelastro v. Prudential-Bache Secs., Inc., 764 F.2d 939, 943 (3d Cir. 1985)).

158 Though *United International Holdings* deals with a private misrepresentation by a seller of a security (Wharf selling the option) and not a third-party corporate issuer, the case works well in the public misrepresentation by corporate issuer context because it is protecting the investment activity (specifically, the investment decision) and that is what Congress sought to protect. See supra Part LA (discussing the legislative history of section 10(b) of the Securities Exchange Act of 1934).

159 See infra notes 262-64 and accompanying text (discussing a “reasonable expectation” test).
tions. Misrepresentations that are tangential or ancillary to a securities transaction should not necessarily trigger 10b-5 liability. A reasonable expectation that the misrepresentation will influence the investment decision ensures a proper nexus between the misrepresentation and the securities transaction in the public misrepresentation context. Other elements of 10b-5 emphasize mindset (i.e., reliance of the plaintiff and scienter of the defendant) but they do not necessarily connect the fraud (which has the mindset elements) to the transaction. An expectation that the misrepresentation will influence the investment decision bridges this gap.

The narrow approach captures too little conduct. This is especially so in cases in which a corporation disseminated misleading information because the security may not have been affected, but an investor was influenced in the purchasing or selling of a security. Even if the misrepresentation is not with respect to the corporation’s own securities, it could influence an investor to purchase or sell a security.

Though Chemical Bank is a category 3 case, in which a third party (not the corporate issuer) is making the misrepresentation, it is still related to the category 2 cases in which the corporation has made a misleading statement. Although the misrepresentation arguably influenced the decision of the banks to “invest” in Frigitemp by accepting the pledge as collateral for the loan, this seems to be the type of common law or commercial fraud that should not be linked to a securities transaction, because the pledge of stock was only ancillary to the transaction. The court’s reasoning is problematic, as it requires that the misrepresentation bear on the value of the security. The stock itself was not affected by the fraud, but to look only at whether the price or value of a stock

---

160 Fletcher, supra note 6, at 936-37 (stating that the third category is similar to the second category because the party who is potentially liable is not an actual buyer or seller of securities, but has made statements affecting the transaction).

161 Judge Van Graafeiland, in his concurring and dissenting opinion, argued that Frigitemp owned all of the Elsters stock, making Elsters a wholly owned subsidiary. Thus, misrepresentations about Frigitemp would directly link to the Elsters stock. Judge Van Graafeiland observed that the pledge of the securities for the $4,000,000 loan was “‘a single transaction, a package deal, no part of which could have stood alone. To say, therefore, that there was no connection between the fraudulent misstatement of solvency and the ‘sale’ of the asset and that ‘the Banks got exactly what they expected’ is simply to blink reality.” Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 945 (2d Cir. 1984) (Van Graafeiland, J., concurring and dissenting) (quoting the majority opinion). Van Graafeiland also stated that both the obligation and the guarantee of its performance were directly connected to the pledge. Id. at 947. See Lowenfels & Bromberg, supra note 54, at 23 (noting that “the dissent’s reasoning appears more cogent”).

162 See Ambassador Hotel Co., Ltd. v. Wei-Chuan Investment, 189 F.3d 1017, 1026 (9th Cir. 1999) (finding that the fraud had to relate to the nature of the security, but recognizing that the fraud did not have to relate to the investment value of the securities themselves, the court found that the fraud must have more than a tangential relation to the securities at issue).
is affected ignores the congressional goal of protecting the investor’s investment activity rather than the stock itself. Thus, this narrow analysis does not suffice to protect investors in a public misrepresentation context, though the court here ultimately came to the correct conclusion: Andersen could not have reasonably expected that its misrepresentation concerning Frigitemp would influence an investor in a transaction in which Elsters stock was a part.

This finding that the fraud was too remotely connected to the securities transaction to trigger 10b-5 liability is appropriate because there was no purchase or sale. Still, the “in connection with” element must be addressed. The problem here, as in all narrow approach cases, is not with the result, but rather with the analysis. Indeed, this may be a prime example of when 10b-5 should not apply. However, the court was too restrictive in its analysis since it ignored the possibility that, in other factual scenarios, the entity making the misrepresentation may influence an investor to purchase or sell a security.163

The narrow approach,164 requiring that the underlying value of the security be affected, fails to recognize that the security may be a part of the transaction in which the person or entity committing the fraud influences the investor’s decision to purchase the security. This type of situation should fall within the scope of 10b-5 liability to protect the investment activity. Further, the narrow approach does not work where a corporation issues a misleading statement about itself, since the misrepresentation may not change the value of the security. It should make no difference whether the corporation makes a misrepresentation about its own securities or a separate corporation’s securities: the requisite connection should be established whenever there is an expectation that an investor will be influenced in her investment decision. Additionally, this approach “conjoins the ‘in connection with’ and materiality elements of the cause of action”165 and, thus, does not treat the two

163 See Lowenfels & Bromberg, supra note 54, at 23 (noting that Anatian embraced a narrow interpretation of the “in connection with” language in holding that the misrepresentation by a bank to induce a customer to enter into a stock-secured loan agreement was too remotely connected).

164 For two other cases requiring that the fraud or misrepresentation affect the underlying value of the security, see Gurwara v. LyphoMed Inc., 937 F.2d 380 (7th Cir. 1991) (holding that an employer’s misrepresentation that an employee remained eligible to exercise his stock options while on short-term disability was not “in connection with” the purchase or sale of securities and was therefore not actionable), and In re Financial Corp. of Am. Shareholder Litig., 796 F.2d 1126 (9th Cir. 1986) (holding that fraudulent advice regarding a company’s accounting treatment of government mortgage certificates was not sufficient to constitute a cause of action).

165 Cox, Hillman & Langevoort, supra note 93, at 690 (citing Arrington v. Merrill
requirements as distinct. A narrow approach may lead to a correct outcome in some cases, but the analysis does not adequately protect investors in the corporate public misrepresentation context.

Thus, it is imperative that a balanced approach to interpreting the “in connection with” requirement is used. The broad approach may not be sufficient if implemented in a way that narrows the conduct it captures, and the narrow approach simply does not capture enough conduct to protect investors. It is where there is a reasonable expectation of influencing the investment decision that the balance is struck.

B. In re Ames Department Stores Inc. Stock Litigation and McGann v. Ernst & Young: Problematic Decisions

The two decisions are problematic because they lay a dangerous groundwork for interpreting the “in connection with” requirement. In *Ames Department Stores Inc. Stock Litigation*, the plaintiff stockholders alleged that Ames’s directors, officers, and investment banker had disseminated false and misleading statements regarding the company’s financial condition. The complaint further alleged that the defendants knew that Ames’s financial situation was deteriorating and that inventory reports were inaccurate. The district court dismissed the 10b-5 complaint on the ground that the “in connection with” requirement was not satisfied. The Second Circuit reversed on two counts. First, it held that, in light of the Supreme Court’s decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, which called for a flexible reading of the requirement, the lower court had not treated the “in connection with” requirement broadly enough, as a matter of law. Second, it held that the district court had made an error of fact by assuming that the plaintiff’s claims were based only on misrepresentations and omissions in a reset note and debenture prospectus, and were not based on misstatements and omissions in press releases and news articles. *Ames* held that the stockholders’ complaint did allege that there was fraud in connection with the sale or purchase of securities.

Lynch, Pierce, Fenner & Smith, 651 F.2d 615 (9th Cir. 1981), and SEC v. Jakubowski, 912 F. Supp. 1273 (N.D. Ill. 1996)).

---

166 991 F.2d 953 (2d Cir. 1993).
167 *Id.* at 955-56.
168 *Id.* at 956.
169 *Id.* at 961.
171 *Ames*, 991 F.2d at 962.
172 *Id.*
173 *Id.* at 968.
Ames assumes that the “in connection with” requirement is met whenever investors rely on false information in public statements and, in so relying, sell or purchase the corporation’s securities. This assumption is problematic. It essentially bars corporations from arguing that there was no connection, and allows investors to claim later that the fraud was connected to their purchase or sale of securities. This approach makes an enormous logical leap—from reliance in the context of fraud to the connection of fraud to a securities transaction—by allowing the same theory to simultaneously satisfy two distinct requirements. As such, it obliterates the “in connection with” requirement by converting it into a question of reliance, which is already a part of the cause of action.

In McGann v. Ernst & Young, the plaintiffs alleged that Ernst & Young, an accounting firm, issued a false and misleading audit opinion concerning the accounts receivable of Community Psychiatric Centers (“CPC”). The audit opinion was included in the Form 10-K filed by CDC with the SEC, which caused an artificial inflation of the price of its stock. When CPC announced a drop in earnings due to a large, uncollectible debt, its stock price plummeted. The McGann court held that the accounting firm could be liable under 10b-5, based on the plaintiffs’ allegation that the firm had made false assertions “in a manner reasonably calculated to influence the investing public.”

Reliance on this holding to find a corporate issuer liable has troubling implications: while cases involving misrepresentations by corporate issuers and cases involving third party misrepresentations

174 Id. at 967 (citing Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968)). The court went on to state that the U.S. Supreme Court’s adoption of the fraud on the market theory in Basic, Inc. v. Levinson, 485 U.S. 224 (1988), supported their position, even though Basic addressed the reliance and materiality requirements of 10b-5 and not the “in connection with” requirement. Ames, 991 F.2d at 967; see also infra notes 223-26 and accompanying text (for a discussion of Basic).

175 The underlying theory is the fraud on the market theory. See infra notes 223-26 and accompanying text (for a discussion of the fraud on the market theory in the context of an “in connection with” requirement analysis).

176 See SEC v. Rana Research, Inc., 8 F.3d 1358, 1361 (9th Cir. 1993) (noting that the defendant treated the concepts of “reliance” and “in connection with” as interchangeable, but they are in fact very distinct). 177 102 F.3d 390 (9th Cir. 1996).

178 Id. at 391.

179 Id.

180 Id.

181 Id. at 397 (citing Wessel v. Buhler, 437 F.2d 279, 282 (9th Cir. 1971), which adopted the reasoning of the Second Circuit in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968), which held that false and misleading statements are made in connection with securities trading “whenever assertions are made . . . in a manner reasonably calculated to influence the investing public”).
tions are similar, an accounting firm does not have the same responsibility to investors as an issuer, especially in a public misrepresentation context. Although accounting firms are indirectly responsible to stockholders, it does not necessarily follow that the same analysis should apply to them and to issuers.

C. Semerenko v. Cendant Corp.: Does There Need to Be a Connection At All?

The Third Circuit essentially nullified the "in connection with" requirement by adopting an overly broad approach, capturing so much conduct that a defendant corporation would have difficulty arguing that any conduct was not in connection with a transaction. In Semerenko, a class of investors appealed the dismissal of their claims under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The action against the Cendant Corporation, its former officers and directors, and its accountant alleged that misrepresentations were made during a tender offer for shares of American Bankers Insurance Group, Inc ("ABI"). The complaint alleged that these misrepresentations had caused the class to purchase shares of ABI stock at artificially inflated prices and that, when the misrepresentations were finally disclosed to the public and the merger agreement was terminated, the class suffered a loss in their investment.

1. The Court's Reasoning

This case does not exemplify a public misrepresentation by a corporation since the plaintiffs were purchasers of ABI's stock rather than Cendant's stock. Cendant initially made a tender

---

182 Fletcher, supra note 6, at 932 (noting the general judicial rejection of a requirement of privity between the defendant and the plaintiff).
183 Id. at 942. "The accountant's role as a non-trading corporate issuer involved in category 2, but the former's role is more attenuated than the latter's, since the alleged misrepresentations made by an accountant do not necessarily go to the merits of the securities and the accountant does not have the issuer/security nexus present in the category 2 cases." Id.
184 See, e.g., Fletcher, supra note 6, at 942. Professor Fletcher noted that in some misrepresentation by accountant cases the intent requirement that many category 2 cases impose is not required. Id. "Thus, an odd situation arises in which the connection appears more attenuated, but the stringency of the 'in connection with' inquiry is actually lessened." Id. (citing SEC v. Drysdale Sec. Corp., 785 F.2d 38 (2d Cir. 1986), and Sharp v. Coopers & Lybrand, 457 F. Supp. 879 (E.D. Pa. 1978)). This may, however, cut in favor of using a similar analysis in order to hold corporate issuers liable for misrepresentations since the attenuation is less.
186 Id.
187 Id.
188 In the public misrepresentation by a corporate issuer context, the plaintiffs generally are purchasers of stock of the corporation that has issued the misleading statement. See Fletcher,
offer to purchase ABI stock at $58 per share and then filed a Schedule 14D-1 that overstated its income during prior financial periods.\textsuperscript{189} When its bid was matched, Cendant raised the bid to $67 per share and agreed to purchase ABI for $3.1 billion in cash and stock of Cendant.\textsuperscript{190} Cendant reported the terms of the merger agreement, but later announced that it had discovered accounting irregularities and explained that the problems occurred within a single business unit.\textsuperscript{191} After the announcement, ABI’s stock price dropped eleven percent, but subsequent press releases maintained that the merger would be completed.\textsuperscript{192} Cendant then announced that the reduction of its income would be twice what was previously disclosed, and that the board of directors had decided to restate its earnings for 1996 and 1997.\textsuperscript{193} As a result, ABI’s stock price fell even further. Cendant later filed an amended 10-K for 1997 filed by Cendant, stating that it had actually lost $217.2 million, rather than $55.5 million. ABI’s stock price declined further. Finally, Cendant announced that it was terminating the merger agreement.\textsuperscript{194}

The Third Circuit held that to satisfy the “in connection with” requirement of 10b-5 in the context of dissemination of misleading information by a corporation, a plaintiff must show that “the misrepresentations in question were disseminated to the public in a medium upon which a reasonable investor would rely, and that they were material when disseminated.”\textsuperscript{195} This approach essentially requires only that a statement be public and material.\textsuperscript{196} The question of whether the facts satisfied this test was remanded to the district court.\textsuperscript{197} In adopting its approach, the court cited \textit{In re Ames Department Stores Inc. Stock Litigation}\textsuperscript{198} and \textit{McGann v. Ernst & Young}\textsuperscript{199} for the proposition that the “in connection with” element can be established by the materiality of the misrepresenta-

\textsuperscript{189} \textit{Semerenko}, 223 F.3d at 170.
\textsuperscript{190} \textit{Id}.
\textsuperscript{191} \textit{Id}.
\textsuperscript{192} \textit{Id} at 170-71.
\textsuperscript{193} \textit{Id} at 171.
\textsuperscript{194} \textit{Id}.
\textsuperscript{195} \textit{Id} at 176.
\textsuperscript{196} But see Williams, supra note 59, at 608 (stating that Third Circuit distilled the entire analysis into materiality and reasonableness).
\textsuperscript{197} \textit{Semerenko}, 223 F.3d at 177-78 (explaining that the standard so adopted was different from the one applied by the district court).
\textsuperscript{198} 991 F.2d 953 (2d Cir. 1993).
\textsuperscript{199} 102 F.3d 390 (9th Cir. 1996).
tion and the means of its dissemination. However, as the Third Circuit misconstrued the standards adopted in these cases, Semerenko is inappropriately broad.

The court argued that McGann and Ames have adopted the standard articulated in SEC v. Texas Gulf Sulphur Co. and therefore have applied an objective analysis that considered the alleged misrepresentation in the context in which it was made. This argument goes on to state that Ames and McGann held that "where the fraud alleged involves the public dissemination of information in a medium upon which an investor would presumably rely, the 'in connection with' element may be established by proof of the materiality of the misrepresentation and the means of dissemination." This statement, however, misconstrues the two cases.

First, Ames cites Texas Gulf Sulphur favorably, yet presumes that the "in connection with" requirement could be established by a mere showing of reliance by the investor on whom the fraud was committed, as opposed to false statements made in a manner reasonably calculated to influence the investing public. Therefore, to say that Ames relied on Texas Gulf Sulphur is inaccurate: Texas Gulf Sulphur did not hold that materiality and the means of dissemination were required to establish the "in connection with" requirement. Moreover, the language quoted from Texas Gulf Sulphur was describing the entire 10b-5 claim and not the holding regarding that element. With regard to the "in connection with" requirement, Texas Gulf Sulphur held that it is satisfied "whenever assertions are made . . . in a manner reasonably calculated to influence the investing public . . . if such assertions are false or misleading or are so incomplete as to mislead, irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes." Thus, Texas Gulf Sulphur used a "reasonably calculated" standard, and not a "materiality and means of dissemination" standard.

Second, McGann adopted the reasoning of Texas Gulf Sulphur, making the argument inaccurate in its statement that the "in connection with" requirement is satisfied under McGann by proof...

200 Semerenko, 223 F.3d at 176.
201 401 F.2d 833 (2d Cir. 1968).
202 Semerenko, 223 F.3d at 176.
203 Id.
204 In re Ames Dep't Stores Inc. Stock Litig., 991 F.2d 953, 967 (2d Cir. 1993).
206 Id.
207 Although Ames argued that materiality and means of dissemination satisfy the Texas Gulf Sulphur "reasonably calculated" standard, "calculation" would seem to denote a mindset of some sort.
of materiality and the means of its dissemination. McGann found that the requirement was satisfied because the accounting firm knew that its fraudulent report would be included in its client's Form 10-K and that the false assertions had therefore been made in a manner calculated to influence the investing public; materiality and means of dissemination were not factors in the determination. Therefore, the reliance of Semerenko on these two cases is misplaced.

2. The Materiality Prong

In holding that the "in connection with" requirement has two prongs, one requiring that the information be material, Semerenko added another layer of materiality to the analysis. A 10b-5 action already requires that the misstatement be material. Semerenko noted that the district court should decide the issue of materiality "only if the alleged misrepresentations are so clearly and obviously unimportant that reasonable minds could not differ in their answers to the question." The court placed more emphasis on materiality than is necessary and, in doing so, made it even more difficult for defendants in 10b-5 actions to argue that the fraud was not adequately connected to a securities transaction. It is hard to imagine a scenario in which an investor would not claim that the information was significant in making her investment decision, especially ex post. That is, after an investor has lost money on an investment, if she later learns that false information was disseminated at the time the securities were purchased, she need only allege that she considered the information significant in making the investment decision. A corporation would have a difficult time rebutting this allegation, regardless of her actual reliance, since it would be nearly impossible to prove that a reasonable investor would not consider such information significant. Indeed, it is hard to imagine what type of apparently positive information a reasonable investor would not find significant, given the impulsive nature of investment decisions as they occur in reality today.

208 McGann v. Ernst & Young, 102 F.3d 390, 397 (9th Cir. 1996).
209 HAZEN, supra note 3, § 12.4[2]; see also Lowenfels & Bromberg, supra note 54, at 6 (noting that the addition of a materiality prong to the "in connection with" requirement analysis "may be more semantic than substantive because the materiality of the misrepresentation is a sine qua non of a 10b-5 violation whether it is viewed separately, or as a part of the 'in connection with' requirement").
211 From the outset, corporations have difficulty proving that a plaintiff did not rely on the alleged misrepresentation, since the U.S. Supreme Court found a rebuttable presumption of reliance based on the fraud on the market theory. Basic, Inc. v. Levinson, 485 U.S. 224 (1988).
Further, Professor Fletcher found that, in using a causation or materiality standard alone to determine whether the “in connection with” element is satisfied, courts overlook the difference between category 1 cases of paradigmatic securities fraud and category 2 cases, where the connection is more attenuated.212 In paradigmatic securities fraud cases, “a seller of securities, for the purpose of inducing another to purchase those securities, deliberately and affirmatively misleads the buyer in a matter that would clearly influence the buyer’s investment decision.”213 In category 2 cases, a corporation issues a statement about itself knowing that it is false, and investors trade on the basis of that information and lose money when the falsity is revealed.214

Requiring only that the dissemination of misleading information be material in order to satisfy the connection between the fraud and the purchase or sale of a security ignores the difference between cases where the purchaser or seller committed fraud and cases where a third party committed fraud. When a corporation issues a misleading statement, requiring materiality alone assumes that there exists the same connection as in the paradigmatic securities fraud cases.215 It should not be assumed that what works in one type of 10b-5 action should be used in all other factual scenarios.216 This point is conceded by Semerenko, as it adds an additional prong, requiring that the information have been disseminated into a medium in which a reasonable investor would rely.217

3. The Public Dissemination Prong

The second prong of an “in connection with” analysis under Rule 10b-5, according to Semerenko, is whether the misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely.218 This prong of the analysis merely calls for the misrepresentation to be made public.219 Semerenko failed to indicate, however, what a reasonable investor would not rely on, leaving this public dissemination prong ill-

212 Fletcher, supra note 6, at 935.
213 Id. at 929-30.
214 Id. at 932.
215 Id. at 933.
216 Id. at 936.
218 Id.
219 At least one court has held that the issuance of a press release, coupled with public trading in the company’s stock, satisfies the “in connection with” requirement. SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993) (additionally noting that “[f]raud touching the intrinsic value of securities and the means of accomplishing the purchase of securities is sufficiently connected with securities transactions to bring the fraud within section 10(b)” of the 1934 Securities Exchange Act).
defined and potentially limitless. Even a technical advertisement in a specialized journal could satisfy the requirement.\textsuperscript{220} This prong of the analysis is problematic, even when examined in conjunction with the materiality prong, because neither poses an obstacle to a plaintiff's satisfaction of the "in connection with" requirement.\textsuperscript{221}

To illustrate, a plaintiff could invoke the fraud on the market theory, which holds that "because the market price of a stock is determined by all publicly available material information regarding the company and its business, misleading statements defraud purchasers or sellers of stock even if they do not directly rely on the misstatements."\textsuperscript{222} This theory is based on the efficient market hypothesis, which posits that financial markets quickly reflect new public information in stock prices.\textsuperscript{223} The fraud on the market theory, however, should not be determinative of whether the "in connection with" requirement is satisfied.

To allow this theory to satisfy two very distinct requirements of 10b-5 (reliance and "in connection with") would be to obliterate the distinction between the two and overlap them. The Supreme Court extended the fraud on the market theory to 10b-5 cases in Basic, Inc. v. Levinson.\textsuperscript{224} The Supreme Court found that a rebuttable presumption of reliance, based on the fraud on the market theory, was consistent with the purposes of the 1934 Securities Exchange Act.\textsuperscript{225} However, the Court made no comment as to whether the fraud on the market theory could create a rebuttable presumption that fraud is "in connection with" the purchase or sale of securities. This creates an insurmountable presumption of liability based on reliance, when the fraud might not be connected to

\textsuperscript{220}HAZEN, supra note 3, § 12.5[1] (noting that an advertisement in a medical journal promoting a new drug could form the basis of 10b-5 liability (citing In re Carter-Wallace, Inc. Sec. Litig., 150 F.3d 153 (2d Cir. 1998))). Liability could even extend to a corporation based on a hyperlink from the company's website to a third party website as a result of the content of the third party website being imputed to the company when impermissible communications are made the SEC warned. Jonathan Bick, Avoid the Hyper-Liability of Hyperlinks: From False Advertising to Copyright Infringement to Problems with the SEC, Web Site Linking Can Be Dangerous, N.J. L.J., May 6, 2002, available at LEXIS, News Group File, Most Recent Two Years.

\textsuperscript{221}See Williams, supra note 59, at 608 (noting that the Third Circuit's approach "virtually assures that every Rule 10b-5 complaint will meet the 'in connection with' requirement. Assuming a plaintiff can meet the already relaxed reliance and causation elements, such cases will almost certainly survive a motion to dismiss").

\textsuperscript{222}Muratori, supra note 23, at 1066 (citing Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

\textsuperscript{223}Id. at 1067 n.72 (citing Donald C. Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. PA. L. REV. 851, 872 (1988)).

\textsuperscript{224}485 U.S. 224 (1988).

\textsuperscript{225}Id. at 245.
the actual transaction, even when it is connected to the ultimate loss. To require that the misleading information have been disseminated into a medium on which a reasonable investor would rely is to confuse the reliance element with the “in connection with” requirement.

Not all publicly available information influences an investment decision. It is true that all publicly available information may affect a particular security, but that, by itself, should not render corporate issuers liable for every false advertisement or marketing campaign. By allowing seemingly any public dissemination to satisfy the “in connection with” requirement, Semerenko has opened the door for potentially unlimited liability. The requirement will no longer be an obstacle to recovery for plaintiffs.

---

226 See In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1419 n.8 (3d Cir. 1997) (noting that the fraud on the market theory affords plaintiffs a rebuttable presumption of reliance if the plaintiffs bought or sold the securities in an efficient market); see also In re Seagate Technology II Sec. Litig., 843 F. Supp. 1341, 1354-55 (N.D. Cal. 1994) (“The essence of the fraud-on-the-market theory of liability is that a plaintiff seeking to recover under Rule 10b-5 for an improper corporate dissemination need not prove his own personal reliance on the particular misrepresentation; instead, reliance is to be presumed.”). It should be noted that generally 10b-5 plaintiffs must prove two types of causation, transaction causation and loss causation. Davis, supra note 3, at 395. Transaction causation requires the plaintiff to show that “but for” the defendant’s fraud, the transaction would not have occurred, or occurred on different terms, which can be established by proof of reliance. Id. Loss causation generally requires the plaintiff to prove that had she known the truth she would not have acted, and in addition, that the fraud was in some way responsible for her loss. Id.; see also Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 186 (2d Cir. 2001) (“While transaction causation is generally understood as reliance, loss causation has often been described as proximate cause, meaning that the damages suffered by Plaintiff must be a foreseeable consequence of any misrepresentation or material omission.”); Suez Equity Investors v. Toronto-Dominion Bank, 250 F.3d 87, 96 (2d Cir. 2001) (stating that transaction causation is based on reliance, while loss causation is akin to proximate cause). This distinction shows that it is possible that a misrepresentation may be connected to a loss, but it may not be connected to the transaction. If it were connected to the loss, but not the transaction, then it would be a type of commercial or common law fraud that should not fall under 10b-5. If it is connected to the loss and the transaction, then it would be foreseeable by the corporation and the fraud should be within the ambit of 10b-5.

227 In In re Carter-Wallace, Inc. Securities Litigation, 150 F.3d 153 (2d Cir. 1998), the fraud on the market theory was utilized to establish the “in connection with” requirement. The plaintiffs, who purchased shares of Carter-Wallace while ads dealing with antiepileptic drugs which later caused deaths ran, alleged that the ads were false and misleading. The court noted that the “in connection with” requirement has been broadly construed, citing Texas Gulf Sulphur as support. It explained that when a plaintiff bases a claim on the fraud on the market theory, a straightforward cause and effect test determines whether the requirement is satisfied. Id. at 156. Technical advertisements in sophisticated medical journals detailing a new drug could be relevant to analysts evaluating the stock of the drug maker. Therefore, a court cannot accurately conclude that the advertisements would never satisfy the “in connection with” requirement. Id. Although this reasoning is troublesome because the fraud on the market theory would satisfy both the reliance element and the “in connection with” requirement at the same time, the court ultimately came to the correct conclusion: the corporation could have reasonably expected that an investor’s investment decision would be influenced by the advertisement.

228 Of course if a corporation knows that the misleading information may affect its stock price, it is all the more reason to hold a corporate issuer liable; in that case the corporation has a reasonable expectation of influencing an investment decision as a result of a change in price.
In the long run, this can hurt corporations (and consequently investors) when the costs of litigation and settlement are passed on to consumers.\textsuperscript{229}

III. WHY 10b-5 LIABILITY SHOULD BE LIMITED

Due to the far reaching implications of the Semerenko analysis of the “in connection with” requirement, it is time to adopt the “reasonable-expectation-of-influencing-an-investment-decision” test,\textsuperscript{230} which can be applied consistently to cases of dissemination of misleading information by a corporation.\textsuperscript{231} Some commentators believe that a broad approach is necessary to protect investors from fraud, while others believe that a narrow approach is necessary to avoid class action abuses.\textsuperscript{232} As a result, corporations may be uncertain as to what constitutes a 10b-5 violation.\textsuperscript{233} This, in turn, can affect their behavior, especially with respect to advertising and disclosures. Moreover, directors may become hesitant to pursue legitimate opportunities that they otherwise would pursue had they not been faced with possible liability and a potentially devastating public relations nightmare. Once an action alleging securities fraud has been initiated, the damage is done, as stock prices may plummet due to a loss of investor confidence.

Although Congress intended to protect investors, it did not intend to protect all investor activities. It merely wished to reduce the risks of dealing in securities by providing a remedy when investors enter unfair transactions.\textsuperscript{234} Unfair transactions would presumably not include those cases where misrepresentations have a tangential or ancillary connection to securities or to a transaction in which securities are involved. Therefore, in such a case, a cor-

\textsuperscript{229} If the “in connection with” requirement is no longer an obstacle, then it would seem that commercial fraud would violate 10b-5, and though honesty should be encouraged, there are other more appropriate causes of action to deter wrongdoing that are not associated with the sale or purchase of securities.

\textsuperscript{230} See infra notes 262-64 and accompanying text (for a discussion of the reasonable expectation test that this Note proposes).

\textsuperscript{231} But see Maloney, supra note 5, at 1181-82 (noting that unlike in situations where there has been a private misrepresentation, lower courts have generally treated cases of public misrepresentations in a consistent manner applying the Texas Gulf Sulphur “reasonably calculated” standard).

\textsuperscript{232} Muratori, supra note 23, at 1057-58; see also Maloney, supra note 5, at 1172-73 (noting that the majority of cases construe the “in connection with” requirement broadly to ensure protections of investors, while some commentators endorse a narrow reading to keep the floodgates to 10b-5 litigation closed).

\textsuperscript{233} Muratori, supra note 23, at 1058 (“[P]ublic companies face an indiscernible boundary between what does and does violate the prohibition. The resultant pall cast on corporate behavior adversely affects the capital markets that the rule was designed to protect.”).

\textsuperscript{234} Wigder, supra note 56, at 1286.
poration should not be held liable. Plaintiffs should not be able to file frivolous actions or strike suits under Rule 10b-5, as these suits could lead to the potentially devastating stigma of securities fraud. Instead, the “in connection with” requirement should be used to limit actions where the fraud is ancillary to the transaction.

A strike suit is a meritless claim that has little chance of success but is brought to harass the defendant and force a settlement that is greater than what the actual claim may be worth. Strike suits in the context of a dissemination of misleading information are class action suits brought by investors under section 10(b) of the Securities Exchange Act of 1934. The plaintiffs typically argue that the defendant corporation used fraudulent or misleading statements to induce investors to purchase securities. This is troublesome because the misleading statements may not have been reasonably expected to influence investors to purchase securities. Due to the wide scope of the 1934 Act, there have been both potential and actual abuses. Corporations fear the stigma that attaches to such suits because companies rely on investor confidence in the securities market to keep the price of their securities high. Conceptually, public accusations that the company is engaged in deceptive practices may diminish the value of the corporation’s securities. Further, as a company relies on the public to provide a market for its goods and services, public accusations may hurt the goodwill and propensity of consumers to return to the market and purchase future goods and services.

Strike suits may be filed without evidence of any actual fraud. Plaintiffs can engage in a fishing expedition that may cost corporations a considerable amount in out of court costs. As a result, corporations tend to favor settlements to avoid the pro-

235 But see Comment, supra note 38, at 162 (arguing that as a matter of equity, a corporation should bear the losses of its fraudulent or knowingly misleading public statements).
236 Wigder, supra note 56, at 1286.
237 Feinstein, supra note 19, at 864.
238 Catina & Schmitt, supra note 19, at 302.
239 Id.
240 Id.; see also Zelizer, supra note 91, at 27 (“Investors are consumers of a unique commodity. Rarely does so much faith and trust go into a purchase. Perhaps naively, investors rely on a company’s reputation . . . when choosing their investments.”).
241 Feinstein, supra note 19, at 865.
242 Id.
243 See Comment, supra note 38, at 168 (discussing the fact that corporations may pass on the costs of litigation and damages to innocent consumers of its products and as a result the corporation will be penalized for the protection of the investing public at the expense of the larger consuming public, which may not be a desirable result).
244 It should be noted that the heightened pleading requirement of the Reform Act assures that individual suits brought in federal courts and class actions have adequate facts prior to discovery. See supra notes 81-83 and accompanying text.
longed stigmatizing effect of a trial and to avoid mounting out-of-
court costs. The potential for abuse under these circumstances is
obvious. In Blue Chip Stamps v. Manor Drug Stores, Justice
Rehnquist stated that "[t]here has been widespread recognition that
litigation under Rule 10b-5 presents a danger of vexatiousness dif-
ferent in degree and in kind from that which accompanies litigation
in general." Justice Rehnquist was concerned given that
corporations would rather settle than suffer public relations dam-
age from allegations of fraud, frivolous lawsuits could be filed to
harass corporations and force easy settlements.

Furthermore, strike suits may hurt investors and markets as
well. Corporations may not disclose information to investors that
they otherwise would have revealed, due to fear of a potential
strike suit based on information that later turns out to be incor-
rect. Therefore investors are unable to make fully informed deci-
sions.

Corporate issuers already can be held liable for a wide array
of conduct under 10b-5, and there is no need to hold them liable
for the dissemination of every misleading statement, especially
when a statement cannot be reasonably expected to influence an
investment decision. For example, unfair exchange ratios lead
to liability under 10b-5, whether in a short-form merger or due to a
misleading proxy statement that fraudulently induced a merger.
There, the connection is clear because the corporate issuer influ-
enced an investor to accept an unfair exchange ratio for her shares.
However, a corporation can be held liable under 10b-5 in other
scenarios as well. A corporation should not be considered liable

245 Catina & Schmitt, supra note 19, at 303.
246 421 U.S. 723 (1975) (though not dealing with the issue of connection, it is illustrative
of the potential for abuse).
247 Id. at 739.
248 Feinstein, supra note 19, at 864.
249 Catina & Schmitt, supra note 19, at 303-04. Arguably, however, this type of situation
  can be handled by the scienter element, since the corporation would not have scienter with re-
  spect to a statement which is true at the time. The "in connection with" requirement, as a prin-
  ciple of limitation, can supplement this and may make a corporation more willing to disclose.
250 See Comment, supra note 38, at 162-63 (arguing that imposition of total liability for a
  statement that is misleading only because of negligence in preparation is undesirable because of
  the slight degree of fault and that damages should therefore be apportioned).
251 Wigder, supra note 56, at 1279 (citing Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d
  Cir. 1967) for the short form merger claim and Swanson v. American Consumer Indus., Inc., 415
  F.2d 1326 (7th Cir. 1969) for the misleading proxy statement claim).
252 See Maloney, supra note 5, at 1174-75 (noting other activities in which a corporation
can be held liable under 10b-5, besides the issuance of misleading information, are a corpora-
tion's silence despite a duty to disclose, tipping, insider trading, and market manipulation); see
also Wigder, supra note 56, at 1278-79 (noting that a claim against a corporate issuer can also
arise under 10b-5 when a corporation issues shares to a controlling shareholder for inadequate
consideration (citing Elfenbein v. Yeager, Fed. Sec. L. Rep. (CCH) ¶ 91,368 (S.D.N.Y. 1964)
when a public statement that contains misleading information is ancillary to a securities transaction.

An additional reason to limit 10b-5 liability of corporations in the public misrepresentation context is that the plaintiff may be alleging common law fraud involving a breach of fiduciary duty or commercial fraud. The "in connection with" requirement is just the device to limit the application of 10b-5 in this situation because the element is precisely what prevents a plaintiff from falsely linking fraud to a securities transaction. For these reasons, the "in connection with" requirement should be used to limit application of 10b-5 against corporations to instances where the corporation reasonably expected to influence an investor's investment decision.

Not only should there be concern for the tension between protecting investors from fraud and corporations from the stigma of securities fraud associated with claims based on statements that could not have been reasonably expected to influence an investment decision, but the integrity of the securities markets and the trading process also must be protected. Although the need to protect investors, the market, and the trading process necessitates a broad analysis of the "in connection with" requirement, the need to protect corporations from the stigma of securities fraud associated with claims based on insignificant statements requires the application of Rule 10b-5 to be limited. This is because negative effects on corporations conceptually can also harm investors, the market, and the trading process. Limiting 10b-5 liability by using the "in connection with" requirement appropriately protects corporations, while still affording investors the protection they deserve under the securities laws. Reasonable investors should understand that some statements are directed to them, whereas other statements, such as advertisements directed at consumers, are not. Therefore, under the proposed application of the "in connection with" requirement,

and Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964)); 14 William Meade Fletcher, Fletcher Cyclopaedia of the Law of Private Corporations § 6853 (perm. ed., rev. vol. 2003) (noting transactions that may create liability under 10b-5 include "stock options; tender offers and takeover bids; exchanges of stock in connection with mergers, consolidations and other reorganizations; issuance by corporation of its own stock; and solicitation of proxies") (citations omitted).

Black, supra note 94, at 540.

See, e.g., Wigder, supra note 56, at 1282 (noting that in Superintendent of Ins. of NY v. Bankers Life and Cas. Co., 404 U.S. 6 (1971) it was clear that the public investors and the securities markets were not harmed and thus the issue was whether the fraud affected the trading process).

See Muratori, supra note 23, at 1082 (noting that fraud in advertising should be the basis of a fraud in advertising claim brought by consumers, not investors because a reasonable investor would not rely on it).
investors would be protected to the extent that they should be, but liability would not be imposed under 10b-5 for claims involving common law fraud or commercial fraud. An investor would be able to bring a claim as a consumer, but only to the extent that a corporation could reasonably expect to influence her investment decision, should a 10b-5 action lie. Investors are protected by limiting 10b-5 actions since a corporation is an aggregation of investor shareholders and any settlement or damages that are paid out to a set of plaintiffs harms all of a corporation's investors; such a pay-out could lower the value of the corporation and, consequently, lower the value of its securities. Alternatively, the money could have been paid out in dividends, or even put to another use.

The market and trading process must also be protected from the dissemination of misleading information by a corporate issuer. Again, however, this can be accomplished by a limited application of 10b-5, through an appropriately restricted use of the "in connection with" requirement. Since reasonable investors should be influenced by investment-related disclosure documents (and not other sources of information) when making investment decisions, limiting the 10b-5 liability of corporations can adequately protect the market. If the efficient market hypothesis is correct and all publicly available information is in fact instantly reflected in the price of stocks, such that, absent fraud, the market price can be trusted to be the correct price absent fraud, those few unreasonable investors who base investment decisions on inappropriate information will have a negligible effect on the market. The counterargument is that, because analysts may take into account all

---

256 It should be noted that an investor should be able to sue for damages when she later finds out that there was a misrepresentation made at the time of the investment decision based on the reliance element since conceivably a corporation could have expected to influence the decision and thus satisfy the "in connection with" requirement based on the reasonable expectation of influencing the investment decision test. See infra notes 262-64 and accompanying text; see also Safecard Serv., Inc. v. Dow Jones & Co., 537 F. Supp. 1137, 1142-43 (E.D. Va. 1982) ("A finding of 'in connection with' where a person sells after knowledge of a fraud would put him in [a]... risk-free situation: if his securities performed less well than he hoped, he could sue... to raise his yield; or if his securities performed up to expectations... he could refrain from suit. By contrast, a seller in a non-fraud situation always takes a risk that the performance of his securities will fall below expectations.").

257 See Comment, supra note 38, at 168 (discussing the fact that the losses caused by a publicly disseminated misleading release usually far exceed the ability of responsible officers to pay, and as a result the corporation compensates the victims).

258 Muratori, supra note 23, at 1082.

259 Id. at 1067 n.72 (citing Langevoort, supra note 219, at 872)).

260 Id. at 1082 (discussing effect upon investors who rely on advertising for their investment decisions).
information in valuing a security and investors may be influenced by non-investment-related disclosures, the consequence is nonetheless market manipulation that should be prohibited. A "reasonable expectation" test is necessary because some information may influence an investment decision even though it is not an investment-related disclosure. The integrity of the market and trading process would be afforded the protection that it requires by limiting the liability of corporations in situations in which the fraud has only a tangential connection to the securities or a transaction involving securities.

To require a reasonable expectation of influencing the investment decision on the part of the party that commits the fraud can serve to limit the 10b-5 actions arising from situations in which misleading information has been disseminated. To satisfy this test, a plaintiff would have to show that the defendant corporation expected that its misrepresentation would influence the investor's decision to purchase or sell a security. This approach changes the focus from such factors as materiality,

---

**Footnotes:**

261 As a matter of policy, it may be better that corporations are not held liable under 10b-5 for forecasts and statements of analysts that take into account information that the corporation disseminates unless the corporation adopts or accepts them because it may require the corporation to police the analyst and specifically reject the forecasts. See, e.g., In re Navarre Corp. Sec. Litig., 299 F.3d 735, 743 (8th Cir. 2002) (noting that generally corporate issuers are not liable for statements by analysts unless they have done something to render the forecasts attributable to the issuers).

262 Although this test sounds similar to the Texas Gulf Sulphur "reasonably calculated" test, it places more emphasis on the mindset of the corporate issuer defendant. The Texas Gulf Sulphur standard may, as it has been interpreted in some cases, place the emphasis on the materiality and the means of dissemination, a standard which this Note argued is too broad in Part II.C. See SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993) (noting that materiality and means of dissemination standard for the "in connection with" requirement developed from the Texas Gulf Sulphur "reasonably calculated" standard).

263 Using a reasonable expectation test for all public misrepresentations by corporate issuers leads to predictability as to when the fraud is in connection with the securities transaction. By contrast, Williams divides the "in connection with" analysis into two categories, "classic genre" and "atypical." Williams, supra note 59, at 609-10. He argues that for "classic genre" cases, where the misrepresentation directly relates to the security involved, the more liberal materiality and dissemination standard should apply. Id. In the "atypical" cases, where the misrepresentation does not directly relate to the security at issue, he argues for a case by case approach. Id. This would be difficult for corporations to apply ex ante, especially with respect to marketing and advertising campaigns. Often ads will contain puffing, and marketers should not be burdened with this analysis before undertaking a marketing plan. A reasonable expectation test, though not a bright line rule, would provide more guidance to what would constitute a violation of 10b-5. See S. REP. NO. 73-792, at 6 (1934) (stating that regulation requires clear statutory provisions). The "classic genre"/"atypical" distinction would be of no use to corporate planners, who are the ones in the position to prevent the misrepresentation from being made public.
reliance, causation and scienter with respect to the fraud, and instead focuses on the defendant's expectation with respect to influencing the investment activity. Though this invokes what looks like a causation inquiry, it would actually allow investors to argue that the causation element is satisfied because the fraud caused the subsequent transaction;\textsuperscript{264} but it would also allow for the defendant corporation to argue that the "in connection with" requirement is not satisfied because it did not expect that the misrepresentation would influence the investor. Thus, both sides can make arguments in a 10b-5 action and corporations would no longer be subject to what amounts to a de minimis test for the "in connection with" requirement.

CONCLUSION

The "in connection with" requirement of SEC Rule 10b-5 is an independent element, and courts should not mix it with other elements of a cause of action. Materiality is already required and public dissemination into a medium in which an investor may rely poses no bar for plaintiffs to overcome. Legislative intent with respect to section 10(b) of the 1934 Act, analysis of major case law precedent, and recent trends in securities legislation point to a more limited application of 10b-5 in public misrepresentation cases. The impact of a 10b-5 action against a corporation, especially in light of the recent and tremendous distrust for the corporate world, can be devastating to a corporation. The federal circuits have interpreted the requirement in an inconsistent fashion. A broad—but not overly broad—approach works best in the context of a public misrepresentation by a corporation to protect investors, as a narrow approach may not capture conduct that should be actionable. The best way to limit frivolous actions is to preclude liability when a misrepresentation is not connected to a securities transaction. The vehicle with which to accomplish this in a 10b-5 action is the "in connection with" requirement. Therefore, while protection of investors dictates a broad approach, courts should look to the "in connection with" requirement as a principle of limitation.

\textsuperscript{264} A plaintiff could argue that there was transaction causation, analyzed separately from the "in connection with" requirement. See supra note 226.
I would like to thank Professor George W. Dent for his assistance in selecting this topic and thoughtful comments, as well as Professor Jonathan L. Entin for his valuable contributions. I would also like to thank my family for their continued support.