No. 06-20856

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

REGENTS OF THE UNIVERSITY OF CALIFORNIA, WASHINGTON STATE INVESTMENT BOARD; SAN FRANCISCO CITY AND COUNTY EMPLOYEES' RETIREMENT SYSTEM; EMPLOYER-TEAMSTERS LOCAL NOS. 175 & 505 PENSION TRUST FUND; HAWAII LABORERS PENSION PLAN; STARO ASSET MANAGEMENT LLC; AMALGAMATED BANK, as Trustee for the Longview Collective Investment Fund; ROBERT V FLINT; JOHN ZEGARSKI; MERVIN SCHWARTZ, JR; STEVEN SMITH; ARCHDIOCESE OF MILWAUKEE; GREENVILLE PLUMBERS PENSION PLAN; NATHANIEL PULSIFER, as Trustee of the Shooters Hill Revocable Trust, Plaintiffs/Appellees,

versus

CREDIT SUISSE FIRST BOSTON (USA), INC., CREDIT SUISSE FIRST BOSTON LLC; PERSHING LLC; MERRILL LYNCH & COMPANY INC; MERRILL LYNCH PIERCE FENNER & SMITH INC; VINSON & ELKINS LLP, Defendants/Appellants.

On Appeal from the United States District Court
for the Southern District of Texas, Houston Division

BRIEF OF *AMICI CURIAE* THE CLEARING HOUSE ASSOCIATION L.L.C., SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA SUPPORTING REVERSAL AND SECONDARY ACTOR APPELLANTS

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CERTIFICATE OF INTERESTED PERSONS

(1) The number and style of this appeal is No. 06-20856, *Regents of the University of California, et al. v. Credit Suisse First Boston (USA), Inc., et al.*

(2) The Clearing House Association L.L.C., The Securities Industry and Financial Markets Association and The Chamber of Commerce of the United States of America are not subsidiaries of other corporations, and no publicly held corporation owns 10% or more of their stock. Amici are unaware of persons with an interest, as set forth in Fifth Circuit Rule 28.2.1, in the outcome of this case, other than the parties to this appeal, and those interested persons listed in their briefs. These representations are made in order that the judges of this court may evaluate possible disqualification or recusal.

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TABLE OF CONTENTS

Page

INTEREST OF AMICI CURIAE 2

A. General Description Of Amici 2

B. Amici's Members Have An Enormous Interest In The Outcome Of This Appeal 4

ARGUMENT 9

A. The District Court's Mega-Class Certification Order Creates Undue Litigation Risks And Unfair Settlement Pressures 9

B. The District Court Erred In Its Interpretation Of Section 10(b) And Rule 10b-5 And Supreme Court Precedent Thereunder 14

1. Under *Central Bank*, Primary Liability Under Section 10(b) And Rule 10b-5 Attaches Only If A Plaintiff Pleads And Proves Each Element As To Each Defendant 15

2. The District Court's Focus On The "Purpose And Effect" Of A Transaction Does Not Adequately Address Whether Each Defendant Used A "Manipulative Or Deceptive Device" As Required By Section 10(b) 19

3. The Court Should Adopt A Test That Clarifies That Only A Defendant's Own Misstatements And Omissions Or Involvement In Well-Defined Types of "Manipulative or Deceptive Conduct" Can Constitute A Primary Violation Of Section 10(b) 23

4. Congress Explicitly Confirmed That Allegations Of Aiding And Abetting Violations Of the Securities Laws Should Be Litigated Solely By The SEC 25

C. Class Certification Is Inappropriate As Individual Issues Predominate 27

TABLE OF AUTHORITIES

Page(s)

Cases

Affiliated Ute Citizens v. United States,
406 U.S. 128 (1972).. 28

Basic, Inc. v. Levinson,
485 U.S. 224 (1988).. 28, 30

Behlen v. Merrill Lynch,
311 F.3d 1087 (11th Cir. 2002) 11

Blue Chip Stamps,
421 U. S. at 739.. 18

Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,
511 U.S. 164 (1994).. passim

Charter Communications, Inc.,
443 F.3d 987 (8th Cir. 2006) 8

Dura Pharmaceuticals, Inc. v. Broudo,
544 U.S. 336 (2005).. 16

In re Dynegy,
339 F. Supp. 2d 804 (S.D. Tex. 2004) 25

Gen'l Tel. Co. v. Falcon,
457 U.S. 147 (1982).. 27

Initial Public Offering Sec. Litig.,
2006 U.S. App. LEXIS 29859, Docket No. 05-3349, Slip Opn. at
46 (2d Cir. Dec. 5, 2006) 30

McCarthy v. Kleindienst,
741 F.2d 1406 (D.C. Cir. 1984).. 15

Nathenson v. Zonagen, Inc.,
267 F.3d 400 (5th Cir. 2001) 16

Pinter v. Dahl,
486 U.S. 622 (1988).. 7, 18

Page(s)

In re Homestore, Inc. Sec. Litig.,
252 F.Supp.2d 1018 (C.D. Cal. 2003.. 22, 25, 27

Santa Fe Indus., Inc. v. Green,
430 U.S. 462 (1977).. 9, 24, 25

SEC v. Fehn,
97 F.3d 1276, 1282 (9th Cir. 1996) 26

Unger v. Amedisys Inc.,
401 F.3d 316 (5th Cir. 2005) 15, 27, 28, 30

Statutes

U.S.C. § 78j(b) ("Section 10(b)") .... passim

Other Authorities

17 C.F.R. § 240.10b-5 ("Rule 10b-5").. 2, 16, 21

H.R. Conf. Rep. 104-369 at 31 (1995)... 12

Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*
43 STAN. L. REV. 497 (1991) 13

The Private Securities Litigation Reform Act of 1995 4

Rules

Federal Rule of Civil Procedure 23(f) 3

Pursuant to Federal Rule of Appellate Procedure 29, The Clearing House Association L.L.C. ("Clearing House"), the Securities Industry and Financial Markets Association ("SIFMA") and the Chamber of Commerce of the United States of America ("Chamber of Commerce") (collectively, "Amici") respectfully submit this brief as *amici curiae* in support of secondary actors, Defendants-Appellants Merrill Lynch, Pierce, Fenner & Smith Inc., Merrill Lynch & Co., Incorporated, Credit Suisse First Boston (USA), Inc. (n/k/a Credit Suisse (USA), Inc., Credit Suisse First Boston LLC (n/k/a Credit Suisse Securities (USA) LLC), and Pershing LLC (f/k/a Donaldson, Lufkin & Jenrette Securities Corporation) (collectively, "Secondary Actor Defendants").

Amici urge this Court to reverse the district court's order certifying a class of tens of thousands attempting to recover, jointly and severally, from dozens of diverse Defendants accused of dissimilar and unrelated conduct (that was unknown to other Defendants) over a course of years. All parties to this appeal consent to the filing of this brief.

The district court's June 5, 2006, Order certifying a class was based, in part, on an erroneous interpretation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. *See* U.S.C.

§ 78j(b) ("Section 10(b)"); 17 C.F.R. § 240.10b-5 ("Rule 10b-5"). Amici submit this brief to urge the Court to reverse and correct the district court's errors and to clarify the legal standard for Section 10(b) liability that should be applied within this Circuit.

INTEREST OF *AMICI CURIAE*

A. General Description Of Amici

The Clearing House was founded over 150 years ago and is an association of leading commercial banks in the United States that provides payment, clearing and settlement services to its member banks and to other financial institutions. The Clearing House regularly appears as *amicus curiae* in cases that present issues of national importance to the commercial banking industry.

SIFMA is a trade association that results from the November 1, 2006, merger of the Securities Industry Association ("SIA") and The Bond Market Association ("BMA"). It brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and

confidence in the markets and the industry. SIFMA works to represent its members' interests in the United States and globally. It has offices in New York, Washington, D.C., and London. Prior to their merger into SIFMA, both the BMA and SIA commonly filed briefs as *amici curiae* in cases raising issues of importance to the securities markets.

The Chamber of Commerce is the world's largest business federation, representing a membership of nearly three million businesses and organizations of every size, in every industry sector and geo-graphical region of the country. A central function of the Chamber of Commerce is to represent the interests of its members in important matters before the courts, Congress, and the Executive Branch. To that end, the Chamber of Commerce files *amicus curiae* briefs in numerous cases addressing issues of vital concern to the Nation's business community.

On November 1, 2006, this Court granted Amici leave to file a brief in support of Secondary Actor Defendants' Federal Rule of Civil Procedure 23(f) petitions to appeal the district court's June 5, 2006, Opinion And Order Re Class Certification (hereinafter "June 5 Order").[1]

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[1] The Chamber of Commerce was not yet an *amicus* during the Rule 23(f) proceedings. Further, and as explained, The Bond Market Association and Securities Industry Association – both *amici curiae* on the Rule 23(f) petition – have now merged into *amicus curiae* here SIFMA.

B. Amici's Members Have An Enormous Interest In The Outcome Of This Appeal

Amici agree with the reasoning and arguments presented in the opening Briefs Secondary Actor Defendants filed on December 4, 2006, in connection with this appeal. To avoid repetition, Amici focus here on certain discrete issues that have the most far reaching effect on their members. Those issues include the certification of a "mega-class" of plaintiffs premised on the incorrect notion that once a defendant has engaged in a single act for which it may be held liable under Section 10(b), and which is part of a greater "scheme," perpetuated by another party, the first defendant may be held jointly and severally liable for all conduct of unaffiliated actors engaged in the scheme, even if the plaintiff neither alleges nor proves that the first defendant knew of, or participated in, the conduct of others or that the losses suffered by investors were based on the first defendant's conduct. *See* June 5 Order at 104-05.

This expansive and unprecedented understanding of joint and several liability in securities class actions is inconsistent with the language of Section 10(b), the Private Securities Litigation Reform Act of 1995 ("PSLRA"), and precedent, all of which require, among other things, that the

plaintiff prove reliance on a particular defendant's conduct and that such defendant's conduct caused plaintiffs' loss.

By eliminating these elements, the scope of Section 10(b) liability is transformed from a regime designed to make plaintiffs whole for the misconduct of culpable defendants into a regime similar to conspiracy liability where any wrongful conduct can subject a defendant to liability based on conduct in which it had no role and "about which it knew nothing." June 5 Order at 104. In this case, the plaintiffs' allegations relate to scores of complex and disparate transactions involving many unrelated actors. The district court's expansive notion of liability and the certification of a mega-class, untethered from the requirement to show class-wide reliance on a particular defendant's conduct, turns class-action securities litigation from a system aimed at the fair resolution of disputes into an engine for extracting settlements that bear no relation to an individual defendant's conduct. The driving force of such litigation, which virtually compels settlements of even unfounded claims, is the extreme *in terrorem* effect of each defendant's potential exposure for losses not fairly traceable to their conduct.

Such rulings undermine public confidence in our courts as tribunals capable of reaching individualized determinations of liability and allocating

responsibility fairly. Members of Amici have a strong interest in ensuring that this nation's securities laws and class action procedures are administered in a fashion that allows resolution of disputes based on the merits of a particular claim, not on fear of ruinous liability for harm caused by another.

Members of Amici also have a strong interest in ensuring that this Court clarifies what conduct by secondary actors in securities markets may give rise to primary liability under Section 10(b) and Rule 10b-5.

As discussed in more detail below, to be *primarily* liable (*i.e.*, not liable for mere aiding and abetting) under Section 10(b) and Rule 10b-5, an actor must itself "use or employ" a "manipulative or deceptive device" in "connection with the purchase or sale of any security." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994). The Supreme Court has confirmed that the language of Section 10(b) does not permit a party to be held liable for aiding and abetting the use of a manipulative or deceptive device in securities transactions. *Id.* Nevertheless, the district court's June 5 Order holds that secondary actors – like Amici's members and the Secondary Actor Defendants here – can be liable where they engage in transactions with securities issuers the "principal

purpose and effect" of which transaction "is to create a false appearance of revenues." June 5 Order at 79.

As explained below, the district court's "principal purpose and effect" test, especially when combined with the court's expansive view of joint and several liability for damages in cases of "scheme" liability, improperly blurs the line between a primary securities law violation and conduct that merely constitutes aiding and abetting, which is not privately actionable under Section 10(b). Because of the great variety and value of the different transactions which investment banks and other secondary actors engage in daily, a clear and stable regulatory environment is of paramount importance. As the Supreme Court explained in *Central Bank*:

> [U]ncertainty and excessive litigation can have ripple effects. For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.

Id. at 189. *See also Pinter v. Dahl*, 486 U.S. 622, 652 (1988).

The district court's class certification order creates exactly the types of uncertainty that the Supreme Court warned against in *Central Bank*.

Indeed, this test has already lead to repeated motion practice and inconsistent and incoherent "clarification" orders in this very case. *See*, *e.g.*, Brief of Credit Suisse First Boston at 33 n.1. Neither lead plaintiff nor the district court, however, has ever varied from the principle that a focus on the "principal purpose and effect" of a transaction can result in liability even where a secondary actor makes no public statements, has no duty of public disclosure, and has engaged in no manipulative securities transaction. Such expansive notions undermine predictability because they eliminate the requirement that regardless of the purported "principal purpose and effect" of a transaction, a defendant's conduct must itself fall independently within the scope of Section 10(b).

As demonstrated below and in Secondary Actor Defendants' briefs, the district court's holding is contrary to the language of Section 10(b), Rule 10b-5, Supreme Court precedent interpreting that language, and case-law from other federal courts (in both this Circuit and others). For example, in *In re Charter Communications, Inc*., 443 F.3d 987 (8th Cir. 2006) *petition for cert. filed*, 75 U.S.L.W. 3034 (Jul. 7, 2006) (No. 06-43) , the Eighth Circuit held that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," *id.* at

990 (quoting *Central Bank*, 511 U.S. at 177), where a "manipulative act" is given the "contextual meaning ascribed in *Santa Fe* [*Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977)]." *Charter*, 443 F.3d at 992. "'Manipulation' is 'virtually a term of art when used in connection with securities markets'" and "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors." *Santa Fe*, 430 U.S. at 474-75. Unlike the district court's test, this standard is easy to understand and to administer and is consistent with the principle that those who make fraudulent statements, or violate a duty to disclose material information, or engage in manipulative securities transactions, may be held liable.

For the reasons set forth in this brief, Amici urge this Court to reverse the district court's class action certification order and to rule that any further class certification proceedings follow the standards for primary liability as set forth in Supreme Court precedent and in *Charter*.

ARGUMENT

A. The District Court's Mega-Class Certification Order Creates Undue Litigation Risks And Unfair Settlement Pressures

As set forth in more detail in Secondary Actor Defendants' Briefs, the district court's certification of a mega-class in this case was premised on the district court's understanding that Section 10(b) authorizes an expansive and

unprecedented view of joint and several liability for all damages flowing from Enron's broad "overarching scheme, including conduct of other scheme participants about which [each particular defendant] knew nothing." *See* June 5 Order at 104. This conclusion, and the class certification order that flowed from it, however, conflict with the requirements of Section 10(b) and the PSLRA that plaintiffs must plead and prove that "the act or omission of the defendant [about which the plaintiff complains] caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Similarly, such a view of joint and several liability for conduct about which a particular defendant "knows nothing" is inconsistent with the PSLRA's emphasis on "knowing" conduct, as well as the PSLRA's requirement that damages be apportioned according to fault. *See* 15 U.S.C. § 78u-4(f)(2) & (3) (requiring knowing conduct and proportionate liability). While a single jury may be able to allocate responsibility appropriately among parties who jointly engage in a particular manipulative or deceptive act that caused specific losses, there is simply no reliable standard by which a jury can allocate fault among parties that engaged in different transactions resulting in different losses to different plaintiffs at different times. The class

certification order will thus render illusory meaningful compliance with the provisions of PSLRA.

It was precisely the intent of Congress in enacting these provisions to make it more difficult "to coerce settlements from deep pocket defendants." 141 Cong. Rec. S17,933, S17,934 (daily ed. Dec. 5, 1995) (statement of Sen. D'Amato). "The procedural reforms enacted by the PSLRA were intended to prevent plaintiffs from bringing 'strike suits' in securities matters. Congress found that the high costs of defending strike suits often forced defendants to settle meritless class actions." *Behlen v. Merrill Lynch*, 311 F.3d 1087, 1090-91 (11th Cir. 2002) (internal footnote and citation omitted). It is ironic that the district court relied primarily on reforms to the joint and several liability provisions of the PSLRA, (June 5 Order at 104), for a holding that not only fails to achieve the goal of the PSLRA but would exacerbate – by many times – the problem the PSLRA intended to eradicate.

The mega-class certification order in this case is contrary to the intent of Congress and creates an environment that plaintiffs can easily exploit to coerce settlements that far exceed any losses reasonably attributable to a particular defendant's alleged misconduct. *See* H.R. Conf. Rep. 104-369 at 31 (1995) (PSLRA intended in part to deter "the targeting of deep pocket

defendants, including accountants, underwriters, and individuals . . . without regard to their actual culpability"). Indeed, the June 5 Order is premised on the notion that each Secondary Actor Defendant may be held liable for $40 billion in damages, even though each particular defendant is alleged only to have known about and participated in a discrete number of acts, the financial effect of which pales in comparison to the potential conspiracy-like exposure.

Potential exposure such as this necessarily creates an environment in which settlements will be guided by factors unrelated to the merits of a claim. Simple arithmetic shows how perverse the effects of such settlement pressure may be. In this case, the purported "scheme" allegedly resulted in forty billion dollars of loss. Assume that a particular secondary actor is accused of engaging in a set of transactions that caused two-hundred million dollars of loss. A *five-percent chance* that that secondary actor will be held jointly and severally liable for the alleged forty billion dollar loss makes a two-billion dollar settlement economically sensible. Thus, the district court encourages the rational actor to settle for an amount that is *ten times* the loss it is even accused of causing when there is only a five-percent chance of those accusations being accepted by a court and a jury.

Plaintiffs understand and exploit this logic. Indeed, one influential study found that the costs and risks of litigation made the merits of securities suits largely irrelevant to the decision to settle. *See generally* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 499-500, 516-17 (1991) (concluding that for practical purposes the settlement value of securities class actions is not a function of merit).

The potential for such expansive liability could change the role of financial institutions in a manner that creates waste, duplication of effort and lost opportunities. If Secondary Actor Defendants face damages liability far in excess of any losses reasonably attributable to their own conduct, they will logically search for ways to limit their exposure. They may, for example, become less willing to engage in transactions involving less well known start-up enterprises, which may be innovative, honest, and productive, but lack the track record of more established companies. They may also choose to guard against such liability by duplicating the role already served by auditors and accountants, requiring repeated assurances and disclosures so that they will not be deemed to be part of a "scheme" if the securities issuer misrepresents a transaction.

These approaches would work a fundamental change in the nature of financial institutions, which now provide a broad array of services to securities issuers that are separate and distinct from the role served by accountants and auditors. Duplicating the efforts of these professionals would entail waste and would add significantly to transaction costs and therefore increase the costs of obtaining capital. This type of waste, and associated diminished opportunities for new businesses, would tend to operate to the detriment of publicly traded companies, their investors, and the general public. *See* H.R. Rep. No. 104-50, at 20 (1995) ("Fear of [securities] litigation keeps companies out of the capital markets.").

B. The District Court Erred In Its Interpretation Of Section 10(b) And Rule 10b-5 And Supreme Court Precedent Thereunder

The district court's June 5 Order was based, in significant part, on its interpretation of Section 10(b) and Rule 10b-5. The district court found *inter alia* that class treatment was appropriate because plaintiffs' claims all arose from an alleged "common course of conduct and scheme to defraud" (June 5 Order at 70) in purported violation of the federal securities laws. On appeal from a class certification order, this Court must look to the lower court's construction of the law and characterization of the claims for relief available thereunder. *Unger v. Amedisys Inc.*, 401 F.3d 316, 320 (5th Cir.

2005) (a district court abuses its discretion when a class certification order is premised on "an erroneous understanding of the governing law"); *McCarthy v. Kleindienst*, 741 F.2d 1406, 1412 n.6 (D.C. Cir. 1984) ("[S]crutinizing plaintiffs' legal causes of action . . . is ordinarily an essential ingredient of the determination whether to allow a case to proceed as a class action.").

1. Under *Central Bank*, Primary Liability Under Section 10(b) And Rule 10b-5 Attaches Only If A Plaintiff Pleads And Proves Each Element As To Each Defendant

Section 10(b) of the Securities and Exchange Act of 1934 makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device." 15 U.S.C. § 78j(b). To implement Section 10(b), the SEC promulgated Rule 10b-5, which provides:

> It shall be unlawful for any person . . .
>
> (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, or
>
> (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.

17 C.F.R. § 240.10b-5.

As elaborated by Supreme Court case law, the elements of a claim under Section 10(b) and Rule 10b-5 are as follows: Defendant must itself (1) use or employ any manipulative or deceptive device; (2) with scienter (*i.e.*, a wrongful state of mind); (3) in connection with the purchase or sale of a security. Plaintiffs must then (4) rely on this conduct; (5) causing economic loss to plaintiffs. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406-07 (5th Cir. 2001).

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court rejected aiding and abetting liability under Section 10(b) and Rule 10b-5 and held that a private right of action lies only for a "primary violation" of these provisions. 511 U.S. at 177. A brief summary of the allegations in *Central Bank* (accepted as true by the Supreme Court) proves helpful.

In *Central Bank*, plaintiffs attempted to hold the Central Bank of Denver, and other secondary actors, liable for aiding and abetting a bond-issuer's primary violation of Section 10(b) and Rule 10b-5. The issuer sold bonds secured by several hundred acres of real property. The bonds required that the value of the real property be worth at least 160 percent of the

outstanding value of the bonds' principal and interest. The bond-issuer, however, neglected to reappraise the real property when local property values began to decline significantly. Central Bank knew this, and its in-house appraiser expressed concerns that the 160 percent threshold was no longer being met in light of declining real property values. Despite this, Central Bank agreed to delay any new appraisal of the property for six months. Prior to completion of a new appraisal, the bond issuer defaulted on the bonds. *Id.* at 167-68.

There was no question that the bond issuer's conduct constituted a primary violation of Section 10(b) and Rule 10b-5. Likewise, there was no question that Central Bank's conduct, if actionable by a private plaintiff, could be actionable only as aiding and abetting. *Id.* at 191. Thus, the issue for the Court was whether Central Bank, and other secondary actors, could be held liable at all to a private party for aiding and abetting the bond issuer's violation of Section 10(b) and Rule 10b-5. The Court held that they could not, as the text of Section 10(b) did not provide for it. *Id.* at 177, 191.

Given that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general" (*id.* at 189 (quoting *Blue Chip Stamps*, 421 U. S. at

739), the area is one "that demands certainty and predictability." *Central Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652). The Court accordingly stressed that in Rule 10b-5 litigation, courts must be especially vigilant in ensuring that private rights of action reach only conduct clearly prohibited by the text of the relevant statute, Section 10(b). *Id*. at 177. *See id.* at 173 ("[A] private plaintiff may not bring a [Rule] 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b).").

Finally, the Court noted that the lack of a private right of action for aiding and abetting did not mean that secondary actors in the securities markets could not be held liable at all. The Court expressed no opinion on whether the SEC could bring an enforcement action for aiding and abetting, expressly limiting the issue presented to whether a private right of action existed for such conduct. *See, e.g., id*. at 191 (Opinion of the Court) and 199 (Stevens, J., dissenting). As explained in detail below, Congress has since granted the SEC express authority to bring enforcement actions against those who aid and abet violators of Section 10(b). 15 U.S.C. § 78t(e). Congress, however, specifically did not overrule *Central Bank*'s holding that private plaintiffs have no corresponding private right of action. *See* § B.4 *infra*. Accordingly, and as held by the Court in *Central Bank*, in order to hold a

secondary actor liable under Section 10(b) and Rule 10b-5, "*all* of the requirements for primary liability under Rule 10b-5 [must be] met." *Central Bank*, 511 U.S. at 191 (emphasis original).

2. The District Court's Focus On The "Purpose And Effect" Of A Transaction Does Not Adequately Address Whether Each Defendant Used A "Manipulative Or Deceptive Device" As Required By Section 10(b)

As discussed, *Central Bank* teaches that a private right of action will not lie against a secondary actor in the securities markets, unless "*all* of the requirements for primary liability under Rule 10b-5 are met" as to that actor. *Id.* (emphasis original).

The legal standard adopted by the district court's class certification order, however, fails to satisfy all of these requirements. The district court held that Secondary Actor Defendants themselves made no actionable statements and had no duty to disclose anything. June 5 Order at 49; *Central Bank*, 511 U.S. at 173 (Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act" in connection with a securities transaction.). The district court nevertheless found that plaintiffs sufficiently alleged that Secondary Actor Defendants used a "manipulative or deceptive device" by engaging in

transactions with Enron that had the "*principal purpose and effect*" of misleading others. June 5 Order at 79 (emphasis added).

The district court's focus on "purpose and effect" cannot substitute for a finding that all the elements of Section 10(b), including the existence of a "manipulative or deceptive device," have been met. An instance in which the focus on "purpose and effect" is deficient is illustrated by plaintiffs' allegations regarding certain loans involving Secondary Actor Defendant Credit Suisse. Plaintiffs allege that Credit Suisse lent $150 million to Enron to be repaid over two years, where "Enron's payments [under the loan] would vary with the price of oil." First Amended Consolidated Complaint ("FACC") at ¶ 706. Plaintiffs allege that Enron misrepresented the transaction on its balance sheet as "liabilities from price risk management." *Id.* But plaintiffs admit that Credit Suisse did *not* misrepresent the transaction and instead "booked the transaction as a loan." *Id.* Nevertheless, plaintiffs allege that the *purpose* of this transaction was "that Enron's true credit situation, liquidity and debt levels . . . be disguised." *Id.* Thus, the allegation that Credit Suisse used a "manipulative or deceptive device" is made by reference to the alleged "purpose" of the transaction and glosses

over the need to find a specific misstatement, duty to disclose or manipulation of the type regulated by Section 10(b).

The focus on the "purpose" of a transaction may address whether the element of scienter is met, but such a focus does not adequately determine whether a transaction was a "manipulative or deceptive device" in the first place. 15 U.S.C. § 78j(b). That Credit Suisse lent Enron money, the repayment of which would vary with the price of oil, is clearly not itself a "manipulative or deceptive device." Plaintiffs allege only that the transaction violated Section 10(b) because "*Enron's* balance sheet misrepresented the transaction" and because Credit Suisse allegedly knew that Enron would disguise its finances. FACC at ¶ 706. The Supreme Court in *Central Bank*, however, clearly did not intend to create a dividing line between primary and secondary liability that rested on whether a particular actor engaged in conduct with a particular state of mind. Indeed, the Court in *Central Bank* accepted the holding of the Court of Appeals that Central Bank had acted with the requisite scienter by delaying an accurate appraisal of the value of the real property which secured the bonds issued by the primary violator. *Central Bank*, 511 U.S. 168-69.

As another federal court has recognized in a similar context:

> Essentially what plaintiff alleges is a scheme to make a deceptive statement or material omission. Yet the principal "wrong" alleged under the rule is the statement, not the scheme. . . . Because plaintiff did not (and cannot) sufficiently allege that any of the business partner or third party vendor defendants substantially contributed to those statements, it cannot state a claim against those defendants for damages resulting from reliance on statements or material omissions.

In re Homestore, Inc. Sec. Litig., 252 F.Supp.2d 1018, 1040-41 (C.D. Cal. 2003), *aff'd in part and rev'd in part by* 452 F.3d 1040 (9th Cir. 2006), *petition for cert. filed*, _ U.S.L.W. _ (Oct. 19, 2006) (No. 06-560).

The issue in this case is similar. Ultimately, it was Enron that decided how to account for each transaction. Without Enron's misreporting, there would have been no "manipulative or deceptive device." Participation by secondary actors in certain transactions does not change the fact that the reporting obligation falls on the issuer, not the party providing financing or other services. Federal courts must be especially careful in this area to create a defined standard that does not conflate aiding and abetting violations of the securities laws with primary violations thereof.

At best, the allegations against Secondary Actor Defendants amount to the precise aiding and abetting liability rejected by *Central Bank*. Reading plaintiffs' allegations generously, they paint the picture that Secondary Actor Defendants, because of their involvement in business

dealings with Enron, knew that Enron was purposely creating an impression of false revenues, *i.e.* that Enron was employing "deceptive devices" in the market. 15 U.S.C. § 78j(b). Liability based on these types of allegations was clearly rejected in *Central Bank*, where the Court accepted that Central Bank knew that the primary violator's failure to have real estate reappraised in light of falling property values created a false impression that bonds were secured by sufficiently valuable real property. As Plaintiffs do not allege that Secondary Actor Defendants used or employed a manipulative or deceptive device, *Central Bank* precludes a finding that their alleged conduct was anything more than aiding and abetting.

3. The Court Should Adopt A Test That Clarifies That Only A Defendant's Own Misstatements And Omissions Or Knowing Involvement In Well-Defined Types of "Manipulative or Deceptive Conduct" Can Constitute A Primary Violation Of Section 10(b)

This Court need look no further than the Supreme Court's decision in *Central Bank* to identify the correct test for determining whether a primary violation has been stated. There, the Supreme Court held "that the statute [Section 10(b)] prohibits *only* the making of a material misstatement (or omission) or the commission of a manipulative act" in connection with the purchase or sale of securities. *Id.* at 177 (emphasis added). *Accord Santa*

Fe, 430 U.S. at 473 (same); *Charter*, 443 F.3d at 991-92. The district court here did not hold that Secondary Actor Defendants could be held liable for "the making of a material misstatement (or omission)." The district court agreed that Secondary Actor Defendants made no such statements, and had no duty to disclose. June 5 Order at 49. Secondary Actor Defendants accordingly could only be liable if they were involved in "the commission of a manipulative act" in connection with the purchase or sale of securities. *Central Bank*, 511 U.S. at 177. They were not.

At first glance, the term "manipulative act" may appear to have a broad sweep. The statute, however, does not prohibit all kinds of manipulation but is limited to specific types of manipulation in connection with the purchase or sale of securities. "The term 'manipulative' in § 10(b) has the limited contextual meaning ascribed in *Santa Fe* [430 U.S. 462]." *Charter*, 443 F.3d at 992. "'Manipulation' is 'virtually a term of art when used in connection with securities markets'" and "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors." *Santa Fe*, 430 U.S. at 474-75. Thus, as Secondary Actor Defendants engaged in neither "the making of a material misstatement (or omission) or the commission of a manipulative act" in

connection with the purchase or sale of securities, they did not directly violate Section 10(b). *Central Bank*, 511 U.S. at 173, 177. *Accord Charter*, 443 F.3d at 992; *In re Dynegy*, 339 F. Supp. 2d 804, 915-16 (S.D. Tex. 2004); *Homestore.com*, 252 F. Supp. 2d at 1040-41, *aff'd in part and rev'd in part by* 452 F.3d 1040 (9th Cir. 2006).

The Eighth Circuit adopted this interpretation of *Central Bank* in its recent decision in *Charter*, 443 F.3d 987. In stark contrast to the interpretation of Section 10(b) adopted by the district court, the *Charter* test is also clear and easily applied. It focuses on whether an actor made a misstatement (or omission where there is a duty to disclose) or whether certain defined types of manipulative securities practices have occurred (*e.g.*, wash sales, matched orders, rigged sales, etc.). Financial institutions, such as Amici's members, can predict whether their conduct may raise the risk of imposition of liability under the federal securities laws, and avoid such conduct and transactions accordingly.

4. Congress Explicitly Confirmed That Allegations Of Aiding And Abetting Violations Of the Securities Laws Should Be Litigated Solely By The SEC

This case is *not* about whether secondary actors can be held liable *at all* for aiding and abetting a "primary violation" of Section 10(b) and Rule

10b-5. They can. The SEC has authority to bring enforcement actions for aiding and abetting. *See, e.g., SEC v. Fehn*, 97 F.3d 1276, 1282 (9th Cir. 1996). And it did so against some of the secondary actors involved in the Enron scandal.

In 1995, just after the Supreme Court issued its decision in *Central Bank*, Congress expressly endorsed the current regime – where private litigants cannot hold aiders and abettors liable but the SEC can – when it passed PSLRA. The Senate Banking Committee reported as follows:

> The Committee considered testimony endorsing the result in *Central Bank* and testimony seeking to overturn this decision. The Committee believes that amending the 1934 Act to provide explicitly for private aiding and abetting liability actions under Section 10(b) would be contrary to [the] goal of reducing meritless securities litigation. The Committee does, however, grant the SEC express authority to bring actions seeking injunctive relief or money damages against persons who knowingly aid and abet primary violators of the securities laws.

Fehn, 97 F.3d at 1283 (quoting S. Rep. No. 98, 104th Cong. (1995)).

Given the extraordinary amount of money at stake in securities class actions – forty billion dollars in this case alone (according to plaintiffs) – it is no surprise that Congress vested exclusive jurisdiction to enforce accusations of aiding and abetting in government officials trusted to wield such discretion appropriately. In light of Congress's willingness to act in

this area, as demonstrated by its swift reaction to *Central Bank*, if the type of liability adopted by the district court is to be sanctioned at all, it should be sanctioned by Congress. *Charter*, 443 F.3d at 993 ("Decisions of this magnitude should be made by Congress."); *Homestore*, 252 F. Supp. 2d at 1039 ("This Court declines to broaden the scope of the securities acts any further, absent direction from Congress.").

C. Class Certification Is Inappropriate As Individual Issues Predominate

"Recognizing the important due process concerns of both plaintiffs and defendants inherent in [class] certification decision[s], the Supreme Court requires district courts to conduct a rigorous analysis of Rule 23 prerequisites." *Unger*, 401 F.3d at 320-21 (citing *Gen'l Tel. Co. v. Falcon*, 457 U.S. 147, 161 (1982)). To certify a class, a district court must find that "the questions of law or fact common to the members of the class predominate over any questions affecting only individual members." Fed. R. Civ. P. 23(b)(3). In securities class actions, "a district court must perform sufficient analysis to determine that class members' [securities] fraud claims are not predicated on proving individual reliance." *Unger*, 401 F.3d at 322.

Recognizing that requiring each individual class member to show reliance would create insurmountable "predominance" problems in securities

class actions, the Supreme Court has approved of rebuttable presumptions of reliance in two circumstances. First, reliance may be presumed where material facts are withheld by an actor with an "obligation to disclose," and the "reasonable investor might have considered [the withheld facts] important" in entering into a securities transaction. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). Second, class-wide reliance may be presumed under the fraud on the market theory, where an actor makes a material misrepresentation to the public, and the security at issue is traded on an efficient market where the price of the security reflects information known to the market. *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988). The district court did not find that Secondary Actor Defendants made material misrepresentations, and the district court expressly recognized that the Secondary Actor Defendants had *no* duty to disclose. June 5 Order at 49. Thus, neither the *Ute* presumption, nor the fraud on the market theory is available.[2]

There is no other basis for presuming that the class, as a whole, relied on *all* of the scores of allegedly deceptive transactions by *all* of the

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[2] These issues are discussed in much greater detail in the Secondary Actor Defendants' briefs. Brief of Appellants Credit Suisse First Boston, *et al.* at 47-58; Brief of Merrill Brief Appellants at 37-47.

defendants. In fact, the district court's remarkable holding in this regard is internally inconsistent with other portions of its order. As noted, under the district court's conspiracy-like "scheme" theory, each defendant can be liable for the conduct of other defendants. The district court presumed that some conduct of certain defendants may not even have been known to other defendants. *See* June 5 Order at 104 (each defendant may be liable for "loss caused by the entire overarching scheme, including conduct of other scheme participants about which it knew nothing"). But if the defendants in this case – sophisticated businesses with knowledge of the markets in general and with Enron in particular – presumably did not know about certain conduct of other defendants, then it strains credulity to believe that the entire class of plaintiffs (or the market in general) would have known about all of the alleged misconduct. There is certainly no basis to *presume* that the entire class, or the market in general, knew about all of that conduct and relied on it. *Basic*, 485 U.S. at 241 ("The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business").

Because there is no basis for presuming reliance by the entire class on all of the alleged acts of defendants, individual issues of proving reliance will predominate and class certification is improper. Fed. R. Civ. P. 23(b)(3); *Unger*, 401 F.3d at 322. *See also In re Initial Public Offering Sec. Litig.*, 2006 U.S. App. LEXIS 29859, Docket No. 05-3349, Slip Opn. at 46 (2d Cir. Dec. 5, 2006) (reversing class certification in Section 10(b) case because "[w]ithout the *Basic* presumption, individual questions of reliance would predominate over common questions").

CONCLUSION

Amici pray that the Court reverse the district court and reaffirm that under the principles set forth by the United States Supreme Court in *Central Bank*, class certification is improper.

December 13, 2006

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH FED. R. APP. 29(d) & 32(a)

I hereby certify that this brief complies with the length limitations of Fed. R. App. P. 29(d) and Fifth Circuit Rule 29.3, because it is no more than one-half the maximum length authorized by the Federal Rules of Appellate Procedure for a party's principal brief. Specifically, I certify that the brief contains 6,464 words as calculated by Microsoft Word's word count tool.

I further certify that this brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and 32(a)(6) in that it has been prepared in a proportionally spaced 14 point font (Times New Roman) produced by Microsoft Word 2003.

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CERTIFICATE OF SERVICE

I hereby certify that the requisite number of true and correct copies of this Brief of Amici Curiae, along with an electronic version on diskette, was sent to the Clerk of this Court by Federal Express overnight delivery in accordance with the Federal Rules of Appellate Procedure and the Circuit Rules of this Court on this 13th day of December, 2006. I further certify that the requisite number of true and correct copies of this Brief of Amici Curiae was served on counsel of record listed on the Service List below by first class mail, postage prepaid, in accordance with the Federal Rules of Appellate Procedure and the Circuit Rules of this Court on this 13th day of December, 2006. In addition, an electronic version of this Brief of Amici Curiae was sent by email to counsel for the parties to this appeal on the same day.

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