Beyond Misrepresentations: Defining Primary and Secondary Liability Under Subsections (a) and (c) of Rule 10b-5

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_Some curs' d fraud / Of enemy hath beguil' d thee, yet unknown, / And me with thee hath ruin' d._

1. INTRODUCTION

Both primary actors, like corporations, and secondary actors, such as accountants, attorneys, and bankers that service businesses, can be primarily liable for fraud under Rule 10b-5. The key determination is whether these actors are primarily or secondarily liable. Primary liability and aiding and abetting liability are not unmistakably partitioned concepts, but courts have recently blurred these grades of liability with respect to claims for employing a device, scheme, or artifice to defraud and for engaging in acts, practices, or courses of business that operate as fraud.

Since the U.S. Supreme Court's unexpected foreclosure of a defrauded investor's civil action against secondary actors in _Central Bank of Denver v. First Interstate Bank of Denver_, circuit courts have grappled with distinguishing primary liability from secondary, or aiding and abetting, liability. Until recently, plaintiffs brought the bulk of securities fraud actions under Rule 10b-5(b), which prohibits the material misrepresentation of facts relied upon by buyers and sellers of securities. Subsections (a) and (c), which prohibit fraudulent schemes and actions

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3. The SEC reports that misrepresentation claims fell within the top ten complaints it received from investors in 2004. However, the number of misrepresentation complaints was down 30.22% from 2003. SEC, Investor Complaints and Questions, http://www.sec.gov/news/data.htm (last visited Jan. 20, 2007).
respectively, were of little significance. Now, defrauded plaintiffs are making creative arguments via subsections (a) and (c) to distinguish primary from secondary liability and potentially circumvent Central Bank’s prohibition of private civil actions against secondary actors.

The Supreme Court rarely grants certiorari for securities cases. Therefore, since the Court recently ruled on loss causation, it is unlikely it will reevaluate its 1994 Central Bank decision with regard to subsections (a) and (c) in the near future. Until then, the courts, the parties, and the SEC must settle on a workable definition for primary and secondary liability under subsections (a) and (c). This challenge is formidable in light of the tripartite split that exists for representational claims under subsection (b). Part II of this comment presents the recent legal history of Rule 10b-5, which does not extend beyond conduct encompassed in Section 10(b), and focuses on the circuit splits regarding misrepresentation claims and the recent judicial uses of subsections

4. The full text of Rule 10(b)-5, 17 C.F.R. § 240.10b-5, as authorized under the 1934 Securities Exchange Act (“1934 Act”), is as follows:

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, 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.

5. This practice may change with the present changes in the composition of the Court.


(a) and (c) in non-representational claims. Part III identifies the problem and describes the underpinnings of fraud liability for investors, companies, and the government. Part IV proposes that the SEC is correct by defining primary violators as those who create fraud with intent.

II. LEGAL BACKGROUND

Section 10(b) and Rule 10b-5 provide no insight in defining primary and secondary liability. The provisions make it unlawful for any person to directly or indirectly: (1) “employ any device, scheme, or artifice to defraud”; (2) “make any untrue statement of a material fact or to omit to state a material fact”; or (3) “engage in any act, practice, or course of business” that operates as fraud or deceit on any person. The text of the provisions does not suggest a distinction in liability.

The legal background of primary and secondary liability under Section 10(b) and Rule 10b-5 begins with Central Bank. Before this Supreme Court decision, lower courts allowed private actions for aiding and abetting securities fraud. There was no need to distinguish between primary and secondary liability because both resulted in private, civil liability. Central Bank complicated fraud claims because it pronounced that a plain reading of Section 10(b) yielded no private cause of action for aiding and abetting fraud.

Before Central Bank, the Supreme Court had also implicitly allowed aiding and abetting claims. For example, although the Court in Dirks v. SEC reversed the D.C. Circuit’s finding that the petitioner had aided and abetted an insurance company’s fraud, it did not reverse the circuit court’s decision on the basis that a secondary fraud claim did not exist. Instead, Justice Powell, writing for the majority, found that Dirks “had no duty to abstain from use of the inside information that he obtained.” The Court did not question the existence of an aiding and abetting action under Section 10(b) and Rule 10b-5 until Central Bank.

A. The Central Bank Decision and the End of Private Actions Against Secondary Violators

The facts of *Central Bank* were mostly uncontested. After a public building authority defaulted on secured bonds, the bond purchasers sued several defendants in connection with the bonds’ sale. Most importantly, the buyers sued the bank that was trustee of the bond issues and alleged that the bank was secondarily liable under Section 10(b) for aiding and abetting the other defendants’ fraud. Using strict statutory interpretation, the Court reversed the Tenth Circuit’s judgment for the buyer and held that no private action for aiding and abetting another’s primary fraud existed under the statute. In taking its surprisingly limited view of secondary liability, the Court stated: “If, as respondents seem to say, Congress intended to impose aiding and abetting liability, we presume it would have used the words ‘aid’ and ‘abet’ in the statutory text. But it did not.” Section 10(b) and Rule 10b-5 did not imply a right of action against secondary violators, but neither the fraud provisions themselves nor the Court defined secondary liability for misrepresentation claims.

B. Post-Central Bank Circuit Splits and Three Diverse Approaches to Defining Securities Fraud Liability

*Central Bank*’s proscription of secondary liability claims radically increased the importance of distinguishing primary violators from secondary violators. In eliminating private secondary actions, the Court complicated securities law and made no mention of what the divide should be between actionable primary claims and non-actionable secondary claims.

13. *Id.* at 191–92.
14. *Id.* at 177.
15. Many practitioners decline to welcome further High Court intervention into this area of securities law, arguing that the Court misses the mark on technical regulatory issues. This author takes the position that these issues appear and have been treated as technical because the issue has not been properly framed before courts, which irregularly hear securities litigation. Fraud is a long-standing legal concept with manifestations in torts and contracts. See, e.g., John Eykyn Hovenden, *A General Treatise on the Principles and Practices by Which Courts of Equity Are Guided As to the Prevention or Remedial Correction of Fraud: With Numerous Incidental Notices of Collateral Points, Both of Law and Equity* (1825). Securities exchanges themselves may be technically complicated transactions, but fraud is not.
The circuit courts have issued divergent opinions on the meanings of primary and secondary liability. The Second and Ninth Circuits hear the most securities litigation in the federal court system but these circuits are on opposite sides of the Section 10(b) liability split. Whereas the Second Circuit adopted the bright-line test in Shapiro v. Cantor,16 the Ninth Circuit applied the substantial participation test.17 The SEC proposed an intermediate test, called the creator test, in Klein v. Boyd.18

1. The Bright-Line Test

The majority of circuits adhere to the bright-line test for secondary liability.19 This test narrows primary liability for secondary actors. Secondary actors are primarily liable under Section 10(b) if they make a misstatement, know or should know that the misstatement will be communicated to investors, and are credited with making the misstatement that is publicly disseminated before investment decisions occur.20 The Tenth Circuit has found: “The critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by the plaintiff.”21 Anything shy of directly or
indirectly making a false or misleading statement is aiding and
abetting and, as such, is not actionable by private claim.22

2. The Substantial Participation Test

Under the substantial participation test, primary violators do
not have to make a misstatement; rather, a significant or substantial
role in the misstatement is sufficient to constitute primary
liability.23 For a defendant to be secondarily liable in a circuit
utilizing the substantial participation test, the plaintiff must prove:

(1) the existence of an independent primary wrong, (2)
actual knowledge or reckless disregard by the alleged aider
and abettor of the wrong and of his or her role in furthering
it, and (3) substantial assistance in the wrong. There is no
requirement in the Ninth Circuit’s test that the aider and
abettor commit a manipulative or deceptive act or that the
injured parties even rely on the substantial assistance given
by the aider and abettor.24

3. The Creator or Intermediate Test

The SEC proposed the creator test for primary liability, a test
subsequently adopted by the Enron court.25 Under the creator test,
an actor is a primary violator if he creates a misrepresentation and
acts with the necessary intent.26 As the Enron court noted, “it
would not be necessary for a person to be the initiator of a
misrepresentation in order to be a primary violator.”27 The SEC
provided a few hypotheticals for clarity. For example, provided “a
plaintiff can plead and prove scienter, a person can be a primary
violator if he . . . writes misrepresentations for inclusion in a
document to be given to investors, even if the idea for those
misrepresentations came from someone else.”28 Further, an actor:

22. See, e.g., Ziemba v. Cascade Int’l, Inc., 256 F.3d 1194 (11th Cir. 2001);
Wright, 152 F.3d 169; Anixter, 77 F.3d 1215.
24. Id. at 967.
25. Presently, no circuits have adopted the creator test. Its greatest
proponent thus far is the district court in Enron.
549, 588 (S.D. Tex. 2002).
27. Id. (quoting Brief of the SEC, supra note 18). The majority of the
SEC’s brief in Enron is substantially the same as its brief in Klein. Id. at 585–
86.
28. Id. at 588 (quoting Brief of the SEC, supra note 18). See also source
cited supra note 26.
who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document. Even assuming such a person knew of misrepresentations elsewhere in the document and thus had the requisite scienter, he . . . would not have created those misrepresentations.  

To summarize, the SEC requires a secondary actor to create the misrepresentation and possess intent to be primarily liable.

Despite the SEC's vague wording, its creator test is a workable solution to distinguishing primary from secondary liability. In addition, it applies equally well to representational and non-representational fraud claims. It achieves a workable test for liability under Rule 10b-5(a), (b), and (c).

Although the creator distinction is practicable, one great problem with the test is that it does not specify the type of intent required.

There is a noticeable difference between intent to: (1) employ any device, scheme, or artifice; make or omit any untrue statement; and engage in any act, practice, or course; and (2) defraud. Fortunately, this difference is common to scienter generally, and scholarship and jurisprudence both provide much assistance on the subject.

C. The Zandford  

Invitation to Non-Misrepresentation Claims

In SEC v. Zandford, the Court stated that it had never held that there must be a misrepresentation to violate Rule 10b-5 fraud provisions.  

This suggestion provided defrauded plaintiffs the impetus to expand the scope of primary liability beyond misstatements. However, Zandford did state, and In re Dynegy, Inc. Securities Litigation later affirmed, that conduct is actionable under Section 10(b) only if it coincides with the sale of securities.

The connection of the fraud to the sale of securities was the

32. Id. at 820.
deciding factor in these cases.\textsuperscript{34} Regardless of the exact ruling, many courts are examining subsections (a) and (c) fraud claims.\textsuperscript{35}

The broad purpose of Section 10(b) also contributes to courts’ willingness to find liability. This purpose is to prevent corporate actors from impairing stock market function and disenabling investors from buying and selling securities at undistorted, although not necessarily accurate, economic valuations.\textsuperscript{36} There are four recent decisions that each add an ingredient to the mix of primary and secondary liability with regard to fraudulent acts and schemes.\textsuperscript{37}

1. The Homestore.com Decision\textsuperscript{38}

\textit{In re Homestore.com, Inc. Securities Litigation} provides information on how to define a scheme to defraud and it prompted an SEC amicus brief addressing “the appropriate test” to find a defendant primarily, rather than secondarily, liable for a scheme to defraud.\textsuperscript{39} In \textit{Homestore.com}, a pension fund plaintiff brought a class action against a business, its partners, and its vendors, alleging that they enhanced its stock price in violation of subsections (a), (b), and (c).\textsuperscript{40} The court declined to expand liability under Section 10(b) for the business partners.\textsuperscript{41} However, the court did find that the complaint sufficiently alleged certain auditors acted with deliberate recklessness and substantially participated in the preparation of errant financial reports.\textsuperscript{42}

The plaintiffs alleged that seventeen of Homestore.com’s business partners and third party vendors violated Rule 10b-5(a) through a scheme to make an omission.\textsuperscript{43} Before dismissing the argument as too attenuated to hold outside defendants primarily

\begin{itemize}
\item \textsuperscript{34} Zandford, 535 U.S. 813; \textit{In re Dynegy}, 339 F. Supp. 2d 804.
\item \textsuperscript{36} \textit{In re Parmalat}, 376 F. Supp. 2d 492.
\item \textsuperscript{37} Id.; \textit{In re Homestore.com}, 252 F. Supp. 2d 1018; \textit{In re Lernout}, 236 F. Supp. 2d 161; \textit{In re Enron}, 235 F. Supp. 2d 549.
\item \textsuperscript{38} \textit{In re Homestore.com}, 252 F. Supp. 2d 1018.
\item \textsuperscript{40} \textit{In re Homestore.com}, 252 F. Supp. 2d at 1020.
\item \textsuperscript{41} Id. at 1037–38.
\item \textsuperscript{42} Id. at 1042–45.
\item \textsuperscript{43} Id. at 1037.
\end{itemize}
liable for a scheme to defraud, the court called the plaintiffs' arguments a "creative and plausible" theory of liability.\(^\text{44}\) In the end, the court declined to be the first to hold simple business partners to a fraudulent corporation liable for a scheme to defraud. The court insisted that, regardless of how the plaintiffs defined "scheme," Section 10(b) primary violations do not result from mere participation or facilitation.\(^\text{45}\) The court did not mention the SEC's brief, and there is no indication that the court was inclined to expressly adopt its "appropriate test."

In its amicus brief, the SEC recommended:

Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5; any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.\(^\text{46}\)

Perhaps envisioning judicial reluctance to adopt its single statement definition of Section 10(b) liability, the SEC offered some hypotheticals to illustrate its point. The SEC suggested the following:

[A] bank that makes a loan, even knowing that the borrower will use the proceeds to commit securities fraud, is at most an aider and abettor. The bank itself has not engaged in any manipulative or deceptive act because there is nothing manipulative or deceptive about the bank's making of the loan.\(^\text{47}\)

Throughout the course of recent litigation, the SEC has continued to adjust this test to secondary actors.

2. The Lernout & Hauspie Decision\(^\text{48}\)

The district court in In re Lernout & Hauspie Securities Litigation allowed a Rule 10b-5 claim against defendants Flanders Language Valley Fund ("FLV") and Mercator, who allegedly created sham companies to inflate earnings for the titular language

\(^{44}\) Id. at 1037–38.
\(^{45}\) Id. at 1038.
\(^{46}\) Brief of the SEC, supra note 39, at 16. See also source cited supra note 19.
\(^{47}\) Brief of the SEC, supra note 39, at 20.
recognition software firm, Lernout & Hauspie. The court examined allegations that FLV and Mercator set up, funded, and operated sham companies that inflated Lernout & Hauspie's earnings by showing bogus revenue from software licensing agreements while omitting research costs on the firm's financial statements.\(^4\) \textit{Lernout & Hauspie} added two items to liability under subsections (a) and (c). The first is the way it framed the allegations, stating that the fraudulent scheme aimed "to defraud the securities market."\(^5\) The decision recognizes that there is more at stake in fraud claims than redressing harm to defrauded investors. The harm extends to the whole market. \textit{Lernout & Hauspie}'s second contribution is that it provides the language the \textit{In re Parmalat Securities Litigation}\(^5\) court used to expand primary liability under subsections (a) and (c). The \textit{Lernout & Hauspie} court held:

\begin{quote}
[T]he better reading of § 10(b) and Rule 10b-5 is that they impose primary liability on any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors, \textbf{even if a material misstatement by another person creates the nexus between the scheme and the securities market}.\(^5\)
\end{quote}

This statement opened the door for the Southern District of New York to circumvent \textit{Central Bank} in its \textit{Parmalat} decision by ignoring the disconnect between the creation of an ordinary business plan, which is, at most, aiding and abetting, and the creation of an otherwise ordinary business plan with the intent to defraud, which is a primary violation.\(^5\) In other words, the \textit{Parmalat} decision exceeds the bounds of \textit{Central Bank} because it confuses the idea that the creator of the scheme does not necessarily have to be the creator of the nexus between the scheme and market with the idea that the creator of the scheme does not have to demonstrate an intent to defraud.

\begin{footnotes}
\item[49.] Id. at 166–69.
\item[50.] Id. at 165.
\item[51.] 376 F. Supp. 2d 472 (S.D.N.Y. 2005).
\item[52.] \textit{In re Lernout & Hauspie}, 236 F. Supp. 2d at 173 (emphasis added).
\item[53.] 376 F. Supp. 2d 472. \textit{See also} discussion \textit{infra} Part II.C.4.
\end{footnotes}
3. The Enron Decision

In *In re Enron Corporation Securities, Derivative & ERISA Litigation*, shareholder plaintiffs brought a securities class action against energy trader Enron and its accountants, attorneys, and bankers. Plaintiffs alleged Enron overstated its assets and understated its debts through regular practices of buying and selling corporate entities in non-arm's length transactions. This large-scale Ponzi scheme likely netted Enron executives over fifty million dollars. In her discussion of secondary liability under subsections (a) and (c), Judge Melinda Harmon adopted the creator test, proposed by the SEC, as an intermediate standard between the bright-line and substantial participation tests. She found the SEC's approach "well reasoned and reasonable, balanced in its concern for protection for victimized investors as well as for meritlessly harassed defendants (including businesses, law firms, accountants and underwriters)." She also found the creator test "consistent with the language of § 10b(b), Rule 10b-5, and *Central Bank.*"

4. The Parmalat Decision

The *In re Parmalat Securities Litigation* court addressed the non-representational liability of financial institutions for structuring transactions that were concealed, or misrepresented, on Parmalat's financial statements. The decision's analysis of Second Circuit, post-*Central Bank* cases shows that there is little consequential difference between misstatements and fraudulent acts and schemes. While the court repeatedly insists that its "analysis is not an end run around *Central Bank,*" its interpretation of the subsection (a) and (c) claims placed misrepresentation claims that would otherwise be

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55. *Id.* at 613–14.
59. *Id.*
61. *Id.*
disallowed under *Central Bank* within the primary liability parameters of (a) and (c).\(^{62}\)

The *Parmalat* court looked to *SEC v. First Jersey Securities, Inc.*,\(^ {63}\) to define the reach of subsections (a) and (c) after *Central Bank*.\(^ {64}\) In *First Jersey*, a broker dealer firm promoted only one security at a time, then encouraged the buyers of this security to sell back to the firm at a low profit.\(^ {65}\) First Jersey then split these repurchased funds and sold the components to different customers at higher prices than it originally charged.\(^ {66}\) The *Parmalat* court found at least three incidences of fraud: fraud on the original customers at the time of purchase, fraud on those same customers at the time of sale, and fraud on the component purchasers.\(^ {67}\) The *Parmalat* court, invoking the benefit of hindsight, stated that the *First Jersey* scenario “might be understood as an example of a scheme in violation of subsections (a) and (c) of Rule 10b-5.”\(^ {68}\) The *First Jersey* court characterized the scenario as fraud by omission, but the *Parmalat* court’s observation is valid because there is little consequential difference between fraud by misstatement and fraud by action or scheme. The creator test levels any potential differences and uniformly applies to subsections (a), (b), and (c).

The *Parmalat* court largely agreed with the *Lernout & Hauspie* court, except that the Second Circuit adheres to the bright-line test, rather than the substantial participation test.\(^ {69}\) This statement does little to negate the *Parmalat* court’s expansion of liability in ways more consistent with the substantial participation test than with the bright-line test to which it purports to adhere. Further, its “final point” that its analysis “is not a back door into liability for those who help others make a false statement or omission in violation of subsection (b)” is inconsistent with the violations of subsections (a) and (c) it found.\(^ {70}\)

The opinion presented three groups of alleged subsections (a) and (c) violations.\(^ {71}\) The first violation related to secondary actors, mainly Citigroup and Banca Nazionale del Lavoro, issuing

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62. *Id.* at 509.
64. *In re Parmalat*, 376 F. Supp. 2d at 499–500.
65. *First Jersey Sec., Inc.*, 101 F.3d at 1457.
66. *Id.*
68. *Id.*
69. *Id.* at 502–03. The Southern District of New York sits in the Second Circuit.
70. *Id.* at 503.
71. *Id.* at 504–05.
securities on and factoring worthless grocery invoices. This first violation is most relevant to this comment because the court denied the secondary actors' motions to dismiss. The second claimed violation involved transactions that mischaracterized debt, in particular, disguising loans as equity investments or assets. Citigroup and Bank of America were the most involved secondary actors in these transactions, and the court decided these allegations at most amounted to aiding and abetting fraud. The third violation related almost entirely to Credit Suisse First Boston and concerned transfers or relinquishments of conversion rights in exchange for the value of bond issues. The court frankly stated, "[I]t is not entirely clear from the complaint whether . . . the transfer or relinquishment was part of a deceptive device or contrivance." The second claimed violation is less relevant to this comment than the first because the court did not find a primary violation of Rule 10b-5, and the third is least relevant because it is not clear the court understands the fraud alleged.

The first asserted violation the Parmalat court found expands primary liability for acts and schemes beyond what the bright-line test allows for misrepresentations. Citigroup's securitization appeared to be a conventional operation. Citigroup would at most be an aider and abettor under the bright-line test because Parmalat's omission that the invoices were worthless under its invoicing system constituted the fraud. Even if Citigroup knew the invoices were worthless, Parmalat's invoicing system made them worthless and falsely represented its cash flow. Thus, the omission is attributable to Parmalat, and Citigroup's transactions on behalf of Parmalat were valid at face value. Citigroup would fail the bright-line test for misrepresentations, but the court entertained the non-representational claims.

III. PROBLEM IDENTIFICATION AND NORMATIVE PERSPECTIVES ON FRAUD REGULATION

As if a three-part split over primary and secondary liability under subsection (b) were not problematic enough, several courts are taking a long, hard look at defrauded plaintiffs' suggestions that secondary actors are primarily liable for fraudulent acts and schemes

72. Id. at 481–82, 488–89.
73. Id. at 505, 517.
74. Id. at 482, 485–87.
75. Id. at 517.
76. Id. at 489–90.
77. Id. at 505.
78. Id. at 504.
to defraud even though these actors cannot be primarily liable for fraudulent misstatements. To say this area of the law is confused is both narrow-sighted and an understatement because of the huge consequences Rule 10b-5 places upon diversely-motivated securities actors. There are three prominent players in the securities "game": investors, companies, and government. Above all, investors and non-fraudulent companies stand to suffer the most from fraud, so it is with their perspective in mind that the legislators and courts should craft a test for liability under subsections (a) and (c).

A. The Investor Perspective

Secondary fraud is a risk investors take when they participate in financial markets. Courts fashioning a division between primary and secondary liability for fraudulent acts and schemes to defraud must recognize that investors take this risk. Many even argue that total risk of fraud is one risk that investors must necessarily take. Even with regulations against fraud in place, all investors assume some risk of fraud. This risk is systematic, or market, risk rather than unsystematic, or individualized, risk. Regulations, like Rule 10b-5, Sarbanes-Oxley, and PSLRA, do not necessarily control the market; the free market and its players regulate themselves. Whistleblower statutes echo this rationale and are an example of the ways legislators recognize the market as primarily self-regulatory. Artificial adjustments play some role as incentives to market players, but incentives simply cannot control. There is irony in that

79. See, e.g., id.
fraud operates as market manipulation in much the same way that regulations are artificial market manipulators.

If some risk of fraud exists regardless of regulation, then Congress fixes or assigns market risk for fraud through its regulations. Congress sets this risk level, at least in part, with Section 10(b), but the courts’ ability to interpret the definition of fraud means the judiciary also plays a large role in setting market risk for fraud.

The Supreme Court has already spoken on whether investor risk includes secondary actor fraud. When the Court decided that no private right of action exists against secondary violators of Rule 10b-5, it adjusted the market risk investors take for fraud in an upward direction. Again, these secondary fraudulent acts are included in the risk all investors take. Additionally, Congress has maintained its refusal to legislatively include secondary liability among actionable claims for fraud, despite the Court’s statement that it would decline to create a comprehensive aiding and abetting liability rule without “expression of congressional direction to do so.” When Congress failed to legislate contrary to Central Bank with regard to private civil actions, it rubber-stamped the inclusion of secondary fraud in market risk.

The legislative branch has continually demonstrated its preference for inclusion of fraud in investor risk. Congress has refused to grant private, civil liability for secondary fraudulent acts by the use of its legislative authority and it has affirmatively legislated in ways suggesting it agrees that investor risk includes secondary actor fraud. Two examples of this legislative expression and acceptance are the Comprehensive Investor Protection Act of 2002 and Section 308 “Fair Funds.”

Congress has proposed many acts aimed to protect investors. Some have passed; some have not. Had Congress enacted the Investor Protection Act of 2002, secondary actors would have been more susceptible to fraud claims because the Act contained a section restoring liability for aiding and abetting corporate fraud.

87. See, e.g., sources cited infra notes 90, 91.
89. Comprehensive Investor Protection Act of 2002, H.R. 3818, § 14 (2002). This piece of legislation was proposed but never passed. See also source cited supra note 19.
Because Congress has legislated in other ways to compensate defrauded investors, the expansion of civil secondary liability under Rule 10b-5(a), (b), and (c) is problematic. At least theoretically, investors can receive double compensation for loss, while companies can pay double penalties. Fair funds are one example where Congress has aimed to pay back defrauded investors.  

Recovery from SEC enforcement actions is deposited in so-called "fair funds" meant to benefit victims of securities violations. In any SEC judicial or administrative action under securities laws, the commission obtains civil penalties, which it adds to the disgorgement monies it has already obtained. Distribution of awards from these fair funds is proportionate to claimed losses, although the SEC emphasizes that disgorgement is not restitution and requests disgorgement based on a reasonable amount of the defendants ill-gotten gains. However, investors have actually received very little from fair funds. Regardless of the amount an investor recovers from fair funds, the fraudulent company is subject to double payment if private, civil liability exists in addition to SEC enforcement actions.

B. The Corporate Perspective

Following the occurrence of fraud at a corporation, much of the damage to the fraudulent corporation is done before and by the fraud itself. Even more damage happens when the SEC makes public allegations of fraud. Those organizations hurt most by the occurrence of fraud are the traded companies that see general decreases in investment activity and negative secondary effects from a decline in stock price. Individuals and financial practitioners often overreact to both information and what they believe others will do. There are cognitive limitations and biases to choices made under

94. Id.
risk, and scholars have just begun to consider the implications of cognitive biases on securities regulations.\footnote{Peter H. Huang, Regulating Irrational Exuberance and Anxiety in Securities Markets, in LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR 502 (Francesco Parisi & Vernon L. Smith eds., 2005).}

However, most securities regulations today focus on cognitive form and content of disclosures, leaving investor emotions unattended. For example, investor anxiety over accounting scandals or corporate malfeasance may cause investors to "pessimistically misperceive, or even ignore completely, any sound fundamentals associated with a particular security during the investment process."\footnote{Id. at 503.} Section 10(b) directs remedial action against the fraudulent companies for the benefit of defrauded investors.\footnote{15 U.S.C. § 79j (2005).} The pessimistic emotions lingering in non-defrauded or previously-defrauded investors hurt non-fraudulent companies because they act as a large, uncertain burden on investor confidence. By contrast, investor confidence is an amorphous concept, one which may not lend itself toward regulation. Further, consideration of investor confidence effects within Section 10(b) secondary liability may not give those subject to the regulation enough notice to comply with anti-fraud goals.

Even scholars who argue that the optimal amount of fraud in a system is not zero, but varies with market conditions, stop short of including intentional frauds in their analysis. They argue that if courts really want to protect investments, then the protection accorded should not turn on whether the knowledgeable party is completely honest.\footnote{Kim Lane Scheppel, LEGAL SECRETS: EQUALITY AND EFFICIENCY IN THE COMMON LAW 164–66 (1988) (citing Michael Darby & Edi Karny, Free Competition and the Optimal Amount of Fraud, 13 J.L. & ECON. 67, 67–88 (1973)).} Complete honesty can eliminate bargaining, and society should encourage mutually beneficial, though not necessarily completely accurate, exchanges.\footnote{Id. at 164 (citing Michael Darby & Edi Karny, Free Competition and the Optimal Amount of Fraud, 13 J.L. & ECON. 67, 67–88 (1973)).}

Expansion of secondary actor liability also raises some specific concerns for parties subject to other securities litigation and proceedings. SEC enforcement proceedings operate separately from private litigation. A trend toward expansion of secondary liability may mean that secondary actors will have difficulty negotiating a settlement with the SEC that does not make these actors susceptible to civil complaints.\footnote{Saparoff & Leone-Quick, supra note 92; see also In re Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161 (2003).} Additionally, statutes of limitations, periods
of repose, and proper venue can become unnecessarily complicated issues when those accused of fraud face multiple actions under statutes and jurisprudence as equally ambiguous as those discussed in this comment.\(^\text{103}\)

C. The Government Perspective

Government action regarding secondary liability lacks consistency. Government loyalties are divided between constituent investors and revenue-producing corporate firms.\(^\text{104}\) Some have suggested that expansion of secondary liability would devastate the industries that blow the whistle on corporate fraud. Large securities class actions have the potential to bankrupt the accounting industry, or at least the "Big Four"\(^\text{105}\) accounting firms responsible for setting the standards of business practice compliance with federal regulations.\(^\text{106}\) Congressional membership composition and demographics likely contribute to governmental hesitance to explicitly expand secondary liability. However, cries for fairness from defrauded constituents do not always fall on deaf ears and provide great material for re-election grandstanding.

Considering behavioral economics with the law gives lawmakers a more comprehensive model to formulate good legislation but it requires them to ask some difficult questions, such as how the law will affect human behavior, how individuals are likely to respond to changes in the law, and why the law takes the form it does. This series of questions represents a positive approach to behavioral economics and the law.\(^\text{107}\) To achieve workable enforcement and deterrence of securities fraud, lawmakers should use this approach with respect to primary and secondary actors. Otherwise, they risk incomplete assessment of transactions and stand to expend resources on a rule that does not work. As

103. Saparoff & Leone-Quick, supra note 92.
105. The accounting firms commonly referred to as the "Big Four" are Deloitte, KPMG, PricewaterhouseCoopers, and Ernst & Young.
discussed earlier with regard to the impetus to expand the scope of primary liability beyond misstatements, the broad purpose of Section 10(b) is to adapt to creative forms of fraud. This positive approach is a general, but adequate, guideline to making laws responsive to different frauds.

The prescriptive task of the law is to use it to achieve specific ends, such as deterring undesirable behavior. The task requires attention to behavioral insights to improve the law’s ability to advance society toward desirable outcomes. This statement begs the question of what outcome society desires, especially in relation to securities fraud. A main predictor of whether plaintiffs bring securities fraud actions is whether the company’s market value has changed. A main predictor is not whether society perceived the company’s behavior as reasonable after the fact. Investors do not want to lose money, so the negative consequence should apply foremost to those who cause the valuation change.

It appears this discussion has come full circle because it is not clear who causes the price change. Companies can commit fraudulent acts about which the public will not know. In such a case, perhaps the one who brings the fraud to light causes the value change. In actuality, the but-for cause of the price change is the bad act because, without the bad act, there would be nothing to disclose. By the same token, false disclosures of fraud that result in price change can be as damning as fraud itself. Loss causation is a perplexing topic, but falls outside the scope of this comment, which instead rests on the idea that the proper end of fraud regulation favors investor and non-fraudulent corporate perspectives.

In summary, the three players—investors, companies, and government—enter the primary and secondary liability divide from different perspectives. Expansion of secondary liability until it encompasses primary liability, like the substantial participation test, ignores the risk of secondary fraud the Court and Congress say investors should bear. But, rigid limitation of primary liability, like the bright-line test, does not protect investors against fraudulent changes in security values. Non-fraudulent companies want to avoid negative effects from volatile investor confidence; and fraudulent companies want to avoid specialized legal uncertainties when subject to private class actions in conjunction with SEC enforcement actions. The government’s task is to implement a balance between primary and secondary liability that enforces and

108. See discussion supra Part II.C.
109. See generally Jolls, Sunstein & Thaler, supra note 107.
110. Id. at 38, 41–42.
111. Id.
deters securities fraud. The creator test, though not perfect, best accommodates all three perspectives because it can protect investors, help stabilize market confidence, and lessen legal uncertainties related to fraud by misstatement and scheme or action.

IV. EVALUATION OF THE CREATOR TEST

The SEC is on the verge of a viable solution to the primary and secondary liability debate, but its creator test is not perfect and requires further articulation to more aptly apply to subsections (a) and (c). Though the test itself is broadly and vaguely worded, it has the potential to embrace solutions to the problems investors and non-fraudulent companies face. The creator test can meet the task of defining primary and secondary actors, and thus liability, in a way the legislature has not. It can fulfill these lofty ends because it reflects a positive approach to behavioral economics and the law. The creator test asks the right questions for society to answer.

SEC attorneys originally submitted the creator test brief in *Klein v. Boyd*. This case settled while on appeal to the Third Circuit, but the Eastern District of Pennsylvania had initially dismissed the plaintiffs’ Section 10(b) and Rule 10b-5 claims against a Philadelphia law firm that had prepared fraudulently incomplete documents provided to plaintiffs by their securities salesman. The law firm created documents that omitted relevant information that the firm could be charged with knowing. The creation of these documents, and the allegedly intentional omission of information, made the law firm a primary violator under the creator test.

The SEC’s creator test is a good approach to defining primary and secondary liability because it incorporates both actions and

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113. *Id.* at 17 (emphasis added).
114. *Id.*
intentions, rejects the bright-line test’s rigidity, and avoids the substantial participation test’s propensity to expand liability.

First, the intent to defraud requirement complements the creation of a fraudulent act requirement. Requiring a fraudulent intent fulfills the notice function needed to affect human behavior. It conveys that purposeful attempts to defraud result in liability. The fraudulent intent requirement makes society aware that it disallows such intent. This awareness is the first step to affecting behavior against fraud. Also, the intent requirement insulates actors from accidentally defrauding someone. For example, an accountant who audits and approves fictitious accounts without knowledge of the falsehood is not primarily liable for fraud because he did not approve the fraudulent accounts with scienter.

Likewise, the active creation requirement shapes a human reaction to fraud that avoids valuation change. As discussed earlier, investors do not want security values to fall and are less concerned with the type of action that caused the change. The action requirement targets prevention of events that lead to price change. The creator test can anticipate and encourage actions that are disincentives to fraud.

Material misstatements, fraudulent acts, and schemes to defraud are often inextricably interwoven. The *Parmalat* court admitted that the First Jersey scheme looked more like a subsection (a) or (c) violation.\(^{115}\) J.P. Morgan’s participation in Enron’s Ponzi scheme, at least according to the plaintiffs’ allegations, also combined misstatements with a scheme to defraud. The bank made “loans” to Enron in a scheme to defraud, then insured against Enron’s default on the loans by purchasing bonds at questionable interest rates and consistently issuing positive reports on Enron’s financial condition.\(^{116}\) It is difficult to tell where the acts end and misstatements begin, so a single test for acts, schemes, and misstatements, is advantageous. By defining primary liability as the intersection of creative action and intent, the creator test applies equally to all subsections of Rule 10b-5.

A second strength of the creator test is that it avoids the most negative aspects of both the bright-line and substantial participation tests. The bright-line test has “the unfortunate and unwarranted consequence of providing a safe harbor from liability to everyone except those identified with misrepresentations by name.”\(^{117}\) The

\(^{115}\) In re *Parmalat* Sec. Litig., 376 F. Supp. 2d 472, 500 (S.D.N.Y. 2005).


\(^{117}\) Brief of the SEC, *supra* note 18, at 12. See also In re *Enron*, 235 F. Supp. 2d 549.
substantial participation test risks engulfing all secondary liability into primary liability. The creator test is neither so rigid that it provides a safe harbor to all except those identified with the fraud, nor so flexible that the line between primary and secondary liability is indivisibly blurred.

Yet, the creator test is weak in two main areas. Its first weakness is that it is less clear than the bright-line test. Further, the test has little legislative and judicial support.

The most and least attractive feature of the bright-line test to distinguish primary from secondary liability is its clarity, which makes it easy both to detect primarily liable actors and to avoid being detected as a primarily liable actor. Primary liability is attributable to those who are identified with the misstatement or fraudulent act or scheme. If the party’s fraudulent act is not attached to its identity, that party is secondarily liable. The bright-line test is a good indicator of liability, so multiple parties with fraudulent intent can participate in the fraud knowing the only party subject to private, civil liability is the one identified with the fraud. The creator test, however, exposes all defendants who create fraud with the intent to defraud to primary liability.

General antifraud provisions contain no mention of any test distinguishing primary from secondary liability. The Enron court’s adoption of the creator test is judicial rule-making. Yet, there is arguably some basis for adopting the creator test over either the bright-line or substantial participation tests simply because the SEC was the entity that proposed the creator test. The Securities Exchange Act of 1934 created the SEC and granted it broad authority over securities. Thus, the SEC acts with statutory authority to administer and enforce securities laws. Further, courts recognize the commission’s expertise and request and review its recommendations. Agency constructions of statutes are proper guidance for courts and litigants.

119. Id.
120. Brief of the SEC, supra note 18, at 12. See also In re Enron, 235 F. Supp. 2d 549.
121. In re Enron, 235 F. Supp. 2d at 588, 590 (adopting the SEC’s creator test).
While the creator test has garnered some support as an agency interpretation of Section 10(b) and Rule 10b-5, it has little support in the federal courts. Presently, Judge Harmon's *Enron* opinion from the Southern District of Texas is the only decision adopting the creator test. The circuits are mostly settled on whether they apply the bright-line or substantial participation tests, and these courts may perceive no need for change.

V. CONCLUSION

Conduct that fails to both create a fraud and be intentional is a secondary violation of Section 10(b)'s general proscription against securities fraud. The consequence of meeting this definition is no private, civil liability for secondary conduct. Defrauded investors may not recover from these less-than-primarily fraudulent actors, and the creator test properly indicates the difference between primary and secondary liability.

Accusations of fraud send investors into panic and corporate executives into a cold sweat. If courts extend private liability to secondary actors for fraudulent acts and schemes, corporate executives will not be the only suits experiencing nervousness. Attorneys, accountants, and bankers are a few of the others who will join their company. Without a carefully crafted test to balance the interests of investors and non-fraudulent companies with those of corporate service industries, all parties' anxiety levels will continue to rise. The creator test distinguishes primary from secondary liability for all types of fraud in a way that directs parties toward proper conduct and preserves retribution against violators. It is an appropriate intermediate guide to fraud.

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126. This statement is accurate as of December 2005.

* The author would like to acknowledge Wendell Holmes for his review of this comment.