No. 06-43

IN THE
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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I.

INTEREST OF AMICUS CURIAE[1]

The California State Teachers' Retirement System ("CalSTRS") is the second largest public pension fund in the United States. CalSTRS manages the retirement funds for California's public school teachers from kindergarten through community college. CalSTRS has a total membership of approximately 800,000, and assets of approximately $171.1 billion. The mission of CalSTRS is to secure the financial future and to sustain the trust of California's educators. As part of this mission, CalSTRS is committed to taking steps to enhance corporate governance and the integrity of the securities markets. The integrity of the securities markets is vital to CalSTRS' mission.

Income to CalSTRS comes from member contributions, school district contributions, investment earnings, and appropriations from the General Fund of the State of California. Like other public pension funds, CalSTRS is obligated to provide guaranteed benefits to its members. As a result, investment losses caused by securities fraud create burdens on all taxpayers.

CalSTRS is the lead plaintiff in the PSLRA class action *In re Homestore.com Securities Litig.*, C.D. Cal. case no. cv 01-11115 SVW. Homestore.com was a company that engaged

1. This brief was not authored, in whole or in part, by counsel for any party. No person or entity other than *amicus* and its counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of this brief and a copy of their consent has been lodged with the Clerk of the Court and is attached to this brief.

in fraudulent transactions with other companies, such as America Online and Cendant Corporation. All of the parties knew that the transactions were shams designed and executed with the primary purpose of enabling each of the companies to misrepresent their financial condition. The *Homestore.com* action gave rise to the decision of the United States Court of Appeals for the Ninth Circuit in *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040 (9th Cir. 2006), in which the United States Court of Appeals for the Ninth Circuit enforced a standard consistent with the position of the Securities and Exchange Commission. This decision is presently the subject of a pending petition for certiorari filed by Cendant Corporation *sub nom Avis Budget Group, Inc. v. California State Teachers' Retirement System,* No. 06-560 (Oct. 19, 2006).

II.

SUMMARY OF ARGUMENT

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) and (c) prohibit knowing conduct that has the principal purpose and effect of creating a false appearance about a public corporation's business and financial results in furtherance of a scheme to defraud investors. The statute and rule have never been limited to those who affirmatively make statements or material omissions. The decision of the Eighth Circuit would place such a limitation on liability under the statute and rule, creating a safe harbor for those who would engage in fraud and impair the securities markets. No such requirement is present in the statute, no such requirement exists in the rule, and the consequences of such a rule would threaten the integrity of the securities markets.

Given the substantive requirements of the federal securities laws and the procedural reforms made to those laws through the enactment of the Private Securities Litigation Reform Act ("PSLRA") and the Securities Litigation Uniform Standards Act ("SLUSA"), judicial rewriting of the Securities Exchange Act and Rule 10b-5 is unnecessary and unwise. The PSLRA and SLUSA made wholesale changes in the manner in which securities claims are litigated and tried. Analysis of trends in securities litigation since the enactment of PSLRA and SLUSA demonstrates that the number of securities actions filed has declined while the recoveries to investors have increased. Institutional plaintiffs, acting in the role of lead counsel under the PSLRA as provided by Congress, have been instrumental in recovering billions of dollars for investors in federal securities actions. These include:

Enron, in which the Regents of the University of California as lead plaintiff secured over $8 billion in recovery for shareholders.

Worldcom, in which the New York State Common Retirement Fund secured over $6 billion in recovery for shareholders.

Tyco, in which the Louisiana State Employees' Retirement System and five other public pension funds secured over $3 billion in recovery for shareholders.

Cendant, in which the California Public Employees' Retirement System secured over $3 billion in recovery for shareholders.

AOL Time Warner, in which the Minnesota State Board of Investment secured over $2.5 billion in recovery for shareholders.

Nortel, in which the Ontario Teachers' Pension Plan Board and Treasury of the State of New Jersey secured over $1 billion in recovery for shareholders.

McKesson, in which the New York State Common Retirement Fund secured over $950 million in recovery for shareholders.

Adelphia, in which Eminence Capital LLC and five other institutional investors secured over $450 million in recovery for shareholders.

Healthsouth, in which the Retirement Systems of Alabama secured over $440 million in recovery for shareholders.

Global Crossing, in which the Ohio Public Employees' Retirement System and Ohio State Teachers' Retirement System secured over $445 million in recovery for shareholders.

Freddie Mac, in which the Ohio Public Employees' Retirement System and Ohio State Teachers' Retirement System secured over $400 million in recovery for shareholders.

These cases demonstrate that fraud and misconduct have occurred in the financial marketplaces and that the federal securities laws have enabled damaged investors to recover at least some of their losses. In sum, these cases demonstrate that the system has been working.

The decision of the Eighth Circuit Court of Appeals would impair the integrity of the markets. It would provide an unwarranted and unnecessary immunity to liability under the federal securities laws. If upheld, the integrity of the financial markets will be placed in jeopardy to an extent not seen since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act and the Securities Exchange Act were enacted to remedy problems in the securities markets which led to the Great Depression. Among "Congress' objectives in passing the Act was to 'insure honest securities markets and thereby promote investor confidence' after the market crash of 1929." *S.E.C. v. Zandford*, 535 U.S. 813, 819 (2002) (quoting *United States v. O'Hagan*, 521 U.S. 642, 658 (1997)). These statutes have been integral parts of the unprecedented economic growth of the United States over the last seventy years.

The Court has recently noted that Section 10(b) and Rule 10b-5 play an "important part" in the "federal regulation of vital elements of our economy." *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71 (2006) ("[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated.").

The Eighth Circuit's decision is contrary to the basic purposes of the federal securities laws, contrary to the plain language of the federal securities laws, and contrary to the interpretation of the federal securities laws given by the Court and by the Securities and Exchange Commission. If the Eighth Circuit's analysis is upheld, a safe harbor for fraud will be created which will lead to devastating consequences for the financial markets and for anyone who tries to plan for their retirement, including California's public school teachers. CalSTRS respectfully suggests that the decision of the Eighth Circuit should be reversed.

III.

ARGUMENT

A. THE PLAIN LANGUAGE OF THE STATUTE SHOULD GOVERN

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for "***any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of [Rule 10b-5].***" 15 U.S.C. § 78j(b).

The language of the statute governs the Court's interpretation. *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 173 (1994) (in determining the scope of conduct prohibited by § 10b "the text of the statute controls our decision[ ] . . . our cases considering the scope of conduct prohibited by 10(b) in private suits have emphasized adherence to the statutory language, '[t]he starting point in every case involving construction of a statute.'") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976)).

In enacting the Securities Exchange Act, Congress predicated liability on the violation of "such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b). In furtherance of this grant of authority, the Securities and Exchange Commission promulgated Rule 10b-5 which prohibits any person from "***directly or indirectly . . . employ[ing] any device, scheme, or artifice to defraud***" or "***engag[ing] 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 a security***." 17 C.F.R. § 240.10b-5(a) and (c). Rule 10b-5 is "coextensive with the coverage of § 10(b)." *S.E.C. v. Zandford*, 535 U.S. 813, 816 n.1 (2002); *see also United States v. O'Hagan,* 521 U.S. at 651; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 214.

Section 10(b) and Rule 10b-5(a) and (c) prohibit conduct beyond making false statements and misleading omissions. The Court has described as examples of prohibited conduct projects, schemes, stratagems, artifices, plans, practices, conduct, and acts. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 n. 20; *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-476 (1977); *United States v. O'Hagan*, 521 U.S. 642, 659 (1997).

Rule 10b-5(b) explicitly prohibits the making of an untrue statement or material omission while Rule 10b-5(a) and (c) apply to conduct other than making an untrue statement or material omission. "To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972). The Court noted that Section 10b-5's "proscriptions, by statute and rule, are broad and, by repeated use of the word 'any', are obviously meant to be inclusive." *Id.* at 151.

The same analysis has been applied to Section 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)), which has analogous language to Rule 10b-5 and uses the disjunctive "or." In analyzing Section 17(a), the Court stated "each subsection proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities – not to narrow the reach of the prior sections." *United States v. Naftalin*, 441 U.S. 768, 774 (1979).

The breadth of the prohibition in Section 10(b) and Rule 10b-5 was noted in *Ernst & Ernst v. Hofchelder* where the Court stated that Section 10(b) was intended as a "'catchall'" provision to "'deal with new manipulative [or cunning] devices.'" 425 U.S. at 202 (quoting Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934)). The Court noted that Rule 10b-5 forbids "any course of conduct, that has the effect of defrauding investors." *Id.* at 212. The Court referenced Webster's International Dictionary (2d ed. 1934) for the definition of device as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive." *Id.* at 199 n.20.

The Court has previously addressed the scope of liability under the Securities Exchange Act and its analysis is not in accord with the Eighth Circuit's decision. In *Central Bank, N.A. v. First Interstate Bank, N.A.,* 511 U.S. 164 (1994), the Court ruled that 10b-5 does not provide for liability for those who aid and abet violations of 10b-5, but went on to state that "any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191. (emphasis in original). *S.E.C. v. Zandford*, 535 U.S. 813, 821 (2002) confirms that liability can apply even in the absence of a material misstatement ("[i]ndeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' that conduct, without more, was a fraud.").

Neither the statute nor the rule provide that the only circumstances in which liability attaches are for misstatements or material omissions. Neither Congress nor the Securities and Exchange Commission have so limited liability. Judicially rewriting the statute and rule to include such a requirement would exempt from liability those who participate in fraudulent schemes. Rewriting the statute and rule would encourage deceptive conduct. Affirming the decision of the Eighth Circuit would frustrate the purpose and goals of Congress and the Securities and Exchange Commission in enacting Section 10(b) and promulgating Rule 10b-5.

Failing to give effect to the terms of Section 10(b) would contravene the basic rule of statutory construction that the Court is to give effect to each word of a statute if possible. *See Alaska Dep't of Envtl. Conservation v. E.P.A.*, 540 U.S. 461 (2004); *Duncan v. Walker,* 533 U.S. 167 (2001). The Eighth Circuit's analysis, which was based on policy considerations extrinsic to the statute, is flawed. "Policy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." *Central Bank*, 511 U.S. at 188.

B. THE COURT HAS RECOGNIZED THAT SECTION 10(b) AND RULE 10b-5 MUST BE CONSTRUED BROADLY TO ACCOMPLISH THEIR GOALS

The Court recognized the broad remedial goals of Section 10(b) and Rule 10b-5 in *Superintendent of Ins. of New York v. Bankers Life*, 404 U.S. 6, 11 n.7 (1971):

> [We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that §10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden variety type of fraud or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws. (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (1967).)

C. THE COURT HAS CONSISTENTLY CONSTRUED SECTION 10(b) AND RULE 10b-5 AS APPLYING TO CONDUCT BEYOND THE LIMITATIONS APPLIED BY THE EIGHTH CIRCUIT

In the more than seventy years since the Securities Exchange Act was enacted, the Court has never limited Section 10(b) and Rule 10b-5 in the way that the Eighth Circuit has done here. Rather, the Court has consistently recognized the broad remedial purpose of Section 10(b) and Rule 10b-5 and applied the statute and rule to various types of conduct.

In *Superintendent of Ins. of New York v. Bankers Life*, 404 U.S. 6 (1971) the Court noted that "§ 10(b) bans the use of any deceptive device in the 'sale' of any security by 'any person'" and thus permitted claims to go forward against both an insider who sold bonds as well as "outside collaborators" who created the paperwork that allowed the insider to misappropriate the proceeds. 404 U.S. at 10.

In *Affiliated Ute*, the Court noted that although Rule 10b-5(b) applies to the making of an untrue statement of a material fact or the omission to state a material fact, "the first and third subparagraphs" – *i.e.*, Rule 10b-5(a) and (c) – "are not so restricted." 406 U.S. at 153; *see also Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977) (referencing prohibited conduct as "deception, misrepresentation, or nondisclosure.").

In *Herman & Maclean v. Huddleston*, 459 U.S. 375 (1983), the Court ruled that primary liability applies to those who cause misrepresentations to be made to investors as well as those who actually make misrepresentations. Discussing primary liability under Section 10(b) and Rule 10b-5, the Court said that Section 10(b) "extends to 'any person' who engages in fraud in connection with the purchase and sale of securities" even if the statements ultimately conveyed to shareholders are not attributed to that person. 459 U.S. at 379 n. 5.

In *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001) a unanimous Court held that

Section 10(b) and Rule 10b-5 liability is not confined to those responsible for misstatements or omissions.

> To succeed in a Rule 10b-5 suit, a private plaintiff must show that the defendant used, in connection with the purchase or sale of a security, one of the four kinds of manipulative or deceptive devices to which the Rule refers, and must also satisfy certain other requirements not at issue here.

532 U.S. at 593.

S.E.C. v. Zandford also makes plain that Section 10(b) and Rule 10b-5 liability may be violated by conduct alone, without any misstatement or omission by the defendant. 535 U.S. at 821 ("each time respondent 'exercised his power of disposition for his own benefit,' that conduct, 'without more,' was a fraud.") (quoting *United States v. Dunn*, 268 U.S. 121, 131 (1925)).

The Eighth Circuit's circumscription of Section 10(b) and Rule 10b-5 is contrary to the language of the statute and rule and contrary to the Court's decisions.

D. THE EIGHTH CIRCUIT'S INTERPRETATION IS CONTRARY TO THAT OF THE SECURITIES AND EXCHANGE COMMISSION

In the *In re Homestore.com Securities Litigation*, the Securities and Exchange Commission filed briefs as *Amicus Curiae* in support of the position of CalSTRS concerning the scope of liability under Rule 10b-5(a) and (c). This brief is available at www.sec.gov/litigation/briefs/homestore_102104.pdf. In its brief, the Securities and

Exchange Commission set forth a standard which is consistent with Rule 10b-5(a) and (c) and contrary to the decision of the Eighth Circuit here. Under the Securities and Exchange Commission's proposed rule, primary liability is described as follows:

> 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 10b-5 and Rule 10b-5(a); 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.

Simpson v. Homestore.com, Inc., No. 04-55665, Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions that Favor Appellant, at * 16.

E. CONGRESS HAS NOT SOUGHT TO CHANGE THE PLAIN LANGUAGE OF THE STATUTE

Congress has not placed any limitation on the scope of liability under Section 10(b) and Rule 10b-5, but instead has confirmed that the statute and rule apply to conduct beyond misrepresentations and material omissions. When the PSLRA was enacted in 1995, Congress provided two separate tests to define a "knowing violation" – one for misrepresentations and the other for conduct. 15 U.S.C. § 78u-4(f)(1). In SLUSA, Congress referred to misrepresentations and omissions in the disjunctive from other deceptive conduct, indicating that each term had separate meaning. 15 U.S.C. § 78bb(f)(5)(E). If Congress had intended Section 10(b) and Rule 10b-5 to apply only to misrepresentations and omissions, then it was wasting its time in drafting the language in the PSLRA and SLUSA cited above. Commentators have noted that these provisions demonstrate that Congress "clearly anticipated the continued liability of secondary defendants." J. Fisch, *In Search of Liability Standards for Secondary Defendants*, 99 Col. L. Rev. 1293, 1313 (1999). These provisions would be "of limited importance unless the general standard of liability holds collateral defendants responsible" for their own fraudulent conduct. *Id.*

F. THE EIGHTH CIRCUIT'S ANALYSIS WILL DAMAGE THE INTEGRITY OF THE MARKETPLACE

If the Eighth Circuit's decision is upheld, there will be serious negative consequences for the financial markets and investors. Investor confidence would be undermined, which would itself lead to a downturn in and flight from the capital markets. Congress expressly recognized the importance of private securities litigation – which it deemed an "indispensable tool" – in helping to "promote public and global confidence in our capital markets" by helping to deter wrongdoing. Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995). The Court has stated that private securities actions "provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)); *see also Lampf v. Gilbertson*, 501 U.S. 350, 374 (1991) (Kennedy, J., dissenting ("private § 10(b) suits constitute 'an essential tool for enforcement of the 1934 Act's requirements'") (quoting *Basic Inc. v. Levinson,* 485 U.S. 224, 231 (1988)).

G. UPHOLDING THE PLAIN LANGUAGE OF SECTION 10(b) AND RULE 10b-5 WILL NOT IMPAIR LEGITIMATE BUSINESS

In reaching a conclusion contrary to the plain language of Section 10(b) and Rule 10b-5, the Eighth Circuit adverted to the potential consequences to the business community. These concerns are legitimate but do not support the Eighth Circuit's decision. The interpretation of Section 10(b) and Rule 10b-5 by the Court and the lower courts, as well as the amendments to the federal securities laws through the PSLRA and SLUSA, insure that legitimate business conduct will not become subject to liability. Only conduct undertaken with the intent to defraud and as part of a scheme will give rise to liability. No business will suffer undue expense or burden because of the heightened pleading standards of the PSLRA which require that a plaintiff plead specific facts giving rise to a strong inference of scienter before an action may go forward. 15 U.S.C. § 78u-4(b)(2).

IV.

CONCLUSION

It is respectfully submitted that the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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