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Federal Securities Liability: When Is a Defendant Primarily Liable?

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A plaintiff does not have a private right of action against alleged aiders and abettors for securities fraud claims under Rule 10b-5. This has led private plaintiffs to bring claims for primary liability against a range of defendants—even those who might seem more like secondary actors than primary violators. This has led courts to clarify the line between aiding and abetting and primary violation. Several recent cases have shed light on the factors that are taken into account, including whether a defendant's behavior appears active or passive, whether there are adequate allegations of scienter, and whether there are adequate allegations of reliance on the part of the plaintiff.

Courts have generally held that a defendant secondary actor must actively participate in fraud or manipulation to be held primarily liable. The secondary actor's passive involvement in fraud or manipulation is insufficient.

For example, in a recent decision, a federal appeals court agreed with plaintiffs that the defendants—a group of securities exchanges—could be primary violators in a manipulative scheme with a group of high-frequency trading (HFT) firms.[1] Specifically, the plaintiffs in that case alleged the exchanges sold products and services that favored HFT firms by providing the firms "with the ability to access market data at a faster rate, obtain non-public information, and take priority over ordinary investors' trades"; in return, "the exchanges received hundreds of millions of dollars in payments for those products and services" and in fees resulting from the firms' increased trading volume on the exchanges. Further, the exchanges allegedly "failed to disclose the full impact that such products and services would have on market activity . . . and falsely reassured ordinary investors that their 'fair and orderly' trading platforms provided 'transparent trading' where all investors received market data in 'real time[.]'" Rather, the exchanges gave the HFT firms "an enhanced glimpse into what the market was doing before others who [did] not have similar access." The exchanges argued that their products and services simply provided the HFT firms a means to commit market manipulation, and their conduct could not be seen as more than aiding and abetting, for which they cannot be held liable. But the court found the allegation sufficient that, by tailoring their products and services to HFT firms, the exchanges increased investors' opportunity costs and artificially manipulated stock prices. Because the

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1 *City of Providence v. Bats Global Mkts., Inc.*, 878 F.3d 36 (2d Cir. 2017).

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plaintiffs sufficiently alleged that the exchanges actively engaged in a manipulative scheme, the court allowed the claims to proceed to discovery.

In contrast, a district court in a different circuit was unpersuaded by the plaintiffs' argument that a defendant futures and options exchange could be primarily liable for fraud where the allegations amounted to only alleged passive involvement.[2] In that case, the exchange published a volatility index that measured the expected volatility of the S&P 500 options, which is a weighted index of 500 United States stocks. The exchange allegedly wanted to profit off the index and was advised by market participants to make the index replicable, meaning that traders could "accumulate a portfolio of the components of [the] index in the same proportion that each component is represented in the index." To make the index replicable, the exchange expanded the number of the S&P 500 options series used in its volatility calculation from four series to 130 series. Shortly thereafter, the exchange created volatility index futures and options, which cash-settled at expiration, occurring the same day each week, and "allowed traders and investors to speculate on the volatility of the stock market." The formula the exchange used to determine the settlement value of the futures and options was, according to the plaintiffs, easy to manipulate because it was replicable and relied heavily on certain S&P 500 options. After the creation of the products, traders began implementing methods to manipulate the instruments' settlement price by trading relevant S&P 500 options on settlement days in a manner that either increased or lowered the instruments' settlement price. The plaintiffs alleged generally that the exchange "knew that manipulation could occur or was occurring" and did not prevent the manipulation because it was "collecting additional fees from the manipulation." Specifically, the exchange acted recklessly by making the index replicable and by failing to prevent the fraud and continuing to promote its products. The plaintiffs further alleged the exchange's desire to profit showed motive to defraud customers. The court, however, found that: (1) replication is not synonymous with manipulation and did not show that the exchange had knowledge of manipulation, (2) the exchange's alleged failure to prevent the manipulation amounted to "essentially . . . an aiding-and-abetting claim," and (3) the exchange's desire to make money was not sufficient to establish motive to defraud. The court therefore dismissed plaintiffs' securities fraud claim against the exchanges.

Another factor courts have considered in evaluating primary liability is whether there was reliance upon the secondary actor's conduct or statements. Without reliance on the part of the plaintiff, courts have often rejected primary liability for secondary actors. For instance, in a securities class action where the lead plaintiff alleged that the defendant law firm failed to disclose a pending merger involving its client to the opposing side of a settlement negotiation, the court dismissed the 10b-5 claims against the law firm, finding that the firm did not have a duty to disclose the transaction and the opposing side could not have relied on any such non-disclosure. There, the defendant law firm was representing a company and two of its controlling shareholders against a derivative action, while simultaneously advising the same parties in a freeze-out merger. After the board of the company voted on the merger, but before the shareholders' vote, the law firm engaged in negotiations with the plaintiff's counsel to settle the derivative action. A day before the shareholders' vote on the merger, the firm informed the plaintiff's counsel that the corporation could no longer negotiate a settlement

2 *In re Chicago Bd. Options Exch. Volatility Index Manipulation Antitrust Litig.*, 2020 WL 421271 (N.D. Ill. Jan. 27, 2020).

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because it entered into a transaction. The plaintiff in the derivative action subsequently brought the securities class action, alleging that the defendant law firm orchestrated a sham freeze-out merger to help the two former shareholder defendants "avoid liability for prior self-dealing and . . . unilaterally purchase [the company's] outstanding shares for less than fair value." The lead plaintiff alleged the firm acted deceptively by failing to disclose the freeze-out merger and engaging in sham negotiations to conceal the merger. The court dismissed the securities fraud claim against the firm because the firm had no duty to disclose the pending merger to the lead plaintiff, and the lead plaintiff did not otherwise rely on the firm's conduct.[3]

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Courts continue to consider the extent of an entity's involvement in the alleged fraud and whether the plaintiff could reasonably or did rely on that entity's conduct or statements. Cases are likely to further explore the boundary between activeness and passiveness, as well as the strength of scienter and reliance allegations.

3 *Siegmund v. Xuelian Bian*, 2018 WL 1611197 (S.D. Fla. Apr. 2, 2018). *See also Geoffrey A. Orley Revocable Tr. U/A/D 1/26/2000 v. Genovese*, 2020 WL 611506, at *7-10 (S.D.N.Y. Feb. 7, 2020) (finding that certain defendants were not liable for misrepresentations that they did not make or disseminate, and where the plaintiff did not rely on those misrepresentations); *In re Longfin Corp. Securities Class Action Litig.*, 2019 WL 3409684 (S.D.N.Y. July 29, 2019) (dismissing the 10b-5 claim against the defendant broker-deal because it was not responsible for the misrepresentations).

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