threatens investors' confidence, making it less likely that they would venture their capital into the United States securities markets.

The problem only threatens to get worse in the future given that hacking in connection with securities trading is an increasingly common phenomenon. *See, e.g., SEC v. Stummer*, 1:2008CV03671 (DAB) (S.D.N.Y. April 17, 2008) (settled case against alleged computer hacker trading on material nonpublic information); *SEC v. Lohmus Haavel & Viisemann, et al.*, 05 CV 9259 (RWS) (S.D.N.Y. Nov. 1, 2005) (same); *SEC v. Blue Bottle Ltd.*, 07-cv-01380 (CSH) (KNF) (S.D.N.Y. Feb. 26, 2007) (default judgment obtained against alleged computer hackers trading on material nonpublic information). Congress enacted the expansive language of Section 10(b) to reach deceitful schemes known to it in 1934 and those yet to be invented. Applying the statute to Dorozhko's conduct effectuates that Congressional purpose.

III. A lie, trickery, or half-truth is "deceptive" whether or not the person making the misrepresentation is acting in breach of a fiduciary duty.

Dorozhko successfully persuaded the district court that his conduct was not "deceptive" because, he claimed, every violation of Section 10(b)

requires proof of a breach of fiduciary duty, even where the defendant lies, engages in misleading conduct, or tells half-truths, and Dorozhko did not owe a fiduciary duty to IMS or Thomson Financial.[17] Though the district court found that Dorozhko's conduct was a device or contrivance, it agreed that his conduct was not deceptive. After an extensive discussion of the law of insider trading cases, which hold that trading in breach of a fiduciary duty is a form of fraud (JA1018-1049), the court concluded that "a breach of fiduciary duty of disclosure is a required element of *any* 'deceptive' device under § 10(b)" JA1017-1018 (emphasis added). The court looked at traditional insider trading decisions, where the fraud consists not in how the information is obtained, but in the fact that it is used to make securities trades. As we have noted, however, this is not such a case.

It is difficult to overstate the degree to which Dorozhko's argument is both extraordinary and untenable. To take only one striking consequence,

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[17] He repeated this argument in this Court in opposition to the Commission's motion to maintain the asset freeze pending appeal – "a violation of § 10(b) and Rule 10b-5 necessarily entails a breach of fiduciary or similar duty." JA1097.

under Dorozhko's view the well-known form of fraud known as a "pump-and-dump" – in which fraudfeasors acquire a block of shares in a company, engage in fraudulent conduct to increase the price, and then use a fraudulent sales campaign to sell the stock to unsuspecting strangers before the truth is disclosed – will no longer be subject to Rule 10b-5 except in the unusual situation where the perpetrators of the scheme owe a fiduciary duty to the investors they deceive.

As we discuss in detail below, fraud and deceit under both the common law and the securities laws are governed by well-established principles: A material misrepresentation, which includes false statements, deceptive actions, and half-truths that render statements made misleading, is fraudulent. Silence, on the other hand, is not deceptive unless a duty to speak is created by a fiduciary relationship or other source.

Dorozhko's interpretation would turn these principles on their head. Instead of being a special case that can give rise to a fraud claim even without an affirmative misrepresentation, the existence of a fiduciary duty would be the predicate to all fraud claims, so that even out-and-out lies would not be deemed "deceptive" unless the liar was breaching a duty in

addition to telling lies. The notion that a lie is not deceptive unless it also breaches a duty is contrary to the plain language and legislative history of Section 10(b), to the common law background against which the securities laws were enacted, to existing case law recognizing that a Section 10(b) violation can be based on fraudulent or deceptive acts without a breach of duty, and to good policy.

A. The language and legislative history of Section 10(b) establish that it reaches all deceptive devices and contrivances, with no requirement of a breach of duty.

We have already discussed the breadth of the language of Section 10(b), and its legislative history, which refers to the provision as a "catchall" and as a prohibition on all cunning schemes, whether new or old. *Supra* at 19-22, 36-40. The notion that what Congress really meant when it enacted Section 10(b) is that fiduciaries – who already had a duty to make full disclosure – are the only ones also prohibited from making affirmative misrepresentations, is simply implausible.

B. The Supreme Court has explained that Section 10(b) follows the common law rule that deception may be shown *either* by affirmative misrepresentations *or* by silence in breach of a duty of disclosure.

1. The distinction between fraud through affirmative misrepresentation and fraud through breach of duty is most clearly illustrated in the Court's insider trading cases.

The general rule that misrepresentations are fraudulent, but that silence is fraudulent only if there is a duty to disclose, is clearly explained in the Supreme Court's insider trading cases. The first case in which the Supreme Court recognized that insider trading was a deceptive device or contrivance under Section 10(b) even though the defendant had not made an affirmative misrepresentation was *Chiarella v. United States*, 445 U.S. 222 (1980) . That case involved an employee of a financial printing company who traded securities based on information that he learned in the course of his employment. 445 U.S. at 224. The employee was convicted of violating Section 10(b) and Rule 10b-5, and he appealed to the Supreme Court on the ground that merely trading based on material, nonpublic information was not securities fraud.

The Court observed that the case "concerns the legal effect of the [defendant's] silence." 445 U.S. at 226. To ascertain that effect, it first looked to the language of the statute and the legislative history, but neither of these provided specific guidance as to whether "silence may constitute a manipulative or deceptive device." *Id.*

However, the Court noted, the common law had long held that silence can be fraudulent when the failure to speak breaches a duty to disclose. The Court explained that the Commission, correctly applying common law principles, had held that corporate insiders had "an affirmative duty to disclose material information which has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders" when they sell securities of the corporation, and that the failure to comply with that disclosure obligation was a violation of Section 10(b). 445 U.S. at 227, *quoting Cady, Roberts & Co.,* 40 S.E.C. 907, 911 (1961). The Commission's conclusion rested on the reasoning of Judge Learned Hand that "the director or officer assumed a fiduciary relation to the buyer by the very sale . . .." 40 S.E.C. at 914 n.23, *quoting Gratz v. Claughton,* 187 F.2d 46, 49 (2d Cir. 1951).

The Supreme Court went on to explain that the Commission's view was well-founded in the common law:

> At common law, *misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent*. But *one who fails to disclose material information* prior to the consummation of a transaction *commits fraud only when he is under a duty to do so.* And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."

445 U.S. at 227-28 (emphasis added).

After reviewing court decisions applying this rule in securities cases, the Court concluded that "silence in connection with the purchase or sale of securities may operate as a fraud actionable under Section 10(b)" where there is "a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." 445 U.S. at 230.[18]

Thus, the courts and commentators typically state that the deception element under Section 10(b) and Rule 10b-5 as requiring proof of *either* "a

[18] The principle that silence is fraudulent only when there is a duty to disclose has been applied in the Court's subsequent insider trading cases, where the dispositive issue in each case has been whether the defendant owed a duty such that failure to make disclosure violated Section 10(b). *See, e.g., O'Hagan*, 521 U.S. 642 (adopting misappropriation theory of liability).

material misrepresentation *or* a material omission as to which he had a duty to speak." *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999) (emphasis added). *See also* Arnold S. Jacobs, *Disclosure and Remedies Under the Securities Laws Database* Part III, Ch. 12.VII.B (March, 2008) ("While some duty must be owed by the defendant to the plaintiff in complete silence cases, under the duty theory, liability for misrepresentations flows absent a fiduciary or other duty between the plaintiff and the defendant.").

2. The Supreme Court has recognized that fraud may be based on either misrepresentations or failure to speak in violation of a duty in non-insider trading cases as well.

A recent example where the Court recognized that fraud can be committed either by misrepresentation or by breach of duty is *Stoneridge*, 128 S. Ct. 761. The issue in that case was whether plaintiffs in a private damages suit could recover from defendants who had allegedly participated in arrangements that allowed a securities issuer to mislead its auditor and issue misleading financial statements affecting its stock price, but who had no role in preparing or disseminating the financial statement. The Court ultimately held that plaintiffs could not recover from these

defendants because plaintiffs had not relied on defendants' statements or representations.

In the course of reaching that conclusion, the Court reviewed the causation requirements for a private right of action under Section 10(b). It explained that proof of reliance on the defendant's "deceptive acts" is ordinarily required, but that reliance may be presumed in two situations, one where the fraud involves failure to disclose in breach of a duty, and where the defendant has made an affirmative misstatement. The first presumption arises "if there is an omission of a material fact by one with a duty to disclose," while the second is present in a case governed by the "fraud-on-the-market" doctrine, "when the statements at issue become public." Neither presumption applied in *Stoneridge* – the first because defendant "had no duty to disclose" and the second because defendants "deceptive acts were not communicated to the public." 128 S.Ct. at 769.

Thus, the Court clearly recognized that duty is not required in cases where there has been affirmatively deceptive conduct – if a duty to disclose were always an element of a Section 10(b) case, there would have been no need to find that the statements had not been communicated to the public

because the case would have been disposed of by the absence of an allegation that defendants owed a duty.

Another case demonstrating that misrepresentations may be the basis for a Section 10(b) claim even without a duty is *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988), where the Court declined to recognize two different standards of materiality, one for "situations where insiders have traded in abrogation of their duty to disclose or abstain" and another covering "affirmative misrepresentations by those under no duty to disclose (but under *the ever-present duty not to mislead*)" (emphasis added). The question whether one or two standards were appropriate would have been meaningless if every Section 10(b) case required proof of breach of duty, even when the defendant has violated the "ever-present duty not to mislead." As in *Stoneridge,* the Court proceeded from the premise that an affirmative deception is a basis for Section 10(b) liability without any breach of duty.

C. This Court has recognized that fraud can violate Section 10(b) even if there is no breach of fiduciary duty.

This Court has reviewed many securities fraud cases, and it has never required proof of a breach of a duty when the defendant has made an

affirmative misrepresentation or engaged in deceptive conduct. *See, e.g.*, *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 102 (2d Cir. 2007) (holding that Rule 10b-5 reaches misstatements by "bankers and non-issuer sellers"). The issue has not previously come up in the way it does here, perhaps because no one has ever suggested before that an affirmative misrepresentation is not deceptive. But there are at least two areas where this Court has explicitly said that there can be deception under Section 10(b) without breach of duty – pump-and-dump schemes and market manipulations.

1. Pump-and-Dump Schemes. This Court has expressly held in a criminal case that a pump-and-dump scheme violates Section 10(b) and Rule 10b-5 even though defendants did not act in breach of a fiduciary duty. *See United States v. Skelly,* 442 F.3d 94 (2d Cir. 2006). The government's primary theory of liability was that defendants pumped up the price of the securities "and then used fraudulent and high-pressure tactics to unload ('dump') the securities on unsuspecting customers." 442 F.3d at 96. However, the government also offered an alternative theory that the defendants breached a fiduciary duty towards their customers.

Defendants were convicted in a general verdict, and they claimed that their convictions should be reversed because the district court misinstructed the jury on the circumstances under which a fiduciary duty is created.

This Court rejected the challenge. First of all, it noted that breach of duty is relevant in failure to disclose cases, not in affirmative misrepresentation cases: "a seller or middleman may be liable for fraud if he lies to the purchaser or tells him misleading half-truths, but not if he simply fails to disclose information that he is under no obligation to reveal." 442 F.3d at 97. Then it held that any error in the instruction on the government's fiduciary theory duty theory was not prejudicial to defendant because there was ample evidence that defendants engineered a pump-and-dump scheme, and it was overwhelmingly likely that any reasonable jury would have convicted based on that theory. 442 F.3d at 98. In other words, this Court affirmed the verdict on the ground that defendants' affirmative fraudulent conduct was clearly proven, even assuming that the fiduciary duty theory was not properly presented to the jury.

2. Manipulation. A second area where this Court has upheld findings of violations under Section 10(b) without proof of a fiduciary duty is market manipulation, *i.e.*, practices such as wash sales, matched orders, or rigged prices "that are intended to mislead investors by artificially affecting market activity." *ATSI Comm., Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99-100 (2d Cir. 2007). Section 10(b) covers "manipulative" devices and contrivances as well as deceptive ones, while Rule 10b-5 forbids fraudulent and deceitful conduct but does not use the word "manipulative." Manipulation is prohibited by Rule 10b-5 because it involves "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.*, 493 F.3d at 100, *quoting Hochfelder*, 425 U.S. at 199.[19]

For our purposes here, the key conclusion is this Court's statement that Rule 10b-5 forbids market manipulation, which is a form of deception,

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[19] Indeed, this Court requires "a showing that an alleged manipulator engaged in market activity aimed at deceiving investors as to how other market participants have valued a security," deception that arises from the fact that "investors are misled to believe that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators." *ATSI*, 493 F.3d at 100 (internal quotation and citation omitted).

"regardless of whether there is a fiduciary relationship between the transaction participants." *Id.*, 493 F.3d at 101. Thus, manipulation is a second example where this Court has expressly found that deception under Section 10(b) does not require proof of a fiduciary duty.

D. The district court's error was in applying the special rules that govern fraud-through-breach-of-duty-to-disclose, such as in traditional insider trading cases, to a case where there was active deception.

The district court's fundamental error was in analyzing Dorozhko's conduct under theories of liability that apply when a fiduciary, after obtaining information lawfully, trades in breach of a duty to either disclose his intention to trade or to refrain from doing so. *O'Hagan*, 521 U.S. 642 (partner in law firm had non-fraudulent access to confidential client information); *Chiarella*, 445 U.S. 222 (employee of printer had non-fraudulent access to confidential customer information). The fraud in that type of case is "consummated, *not when the fiduciary gains the confidential information*, but when, without disclosure to his principal, he uses the information to purchase or sell securities." *See O'Hagan*, 521 U.S. at 656 (emphasis added); *Chiarella*, 445 U.S. at 227-28. In the present case, in contrast, the fraud was the affirmative conduct by which Dorozhko

deceptively obtained the information. Nothing in the language of the statute imposes a duty requirement when the wrongdoer defrauds through acts of deception rather than by remaining silent.

An argument very similar to Dorozhko's was rejected in *United States v. Riggs,* 739 F. Supp. at 418-19, a case that was discussed above in showing that Dorozhko's conduct was deceptive. *Supra* at 34-35. Like Dorozhko, the defendant in that case claimed that he could not be liable for fraudulently obtaining confidential information because he owed no fiduciary duty to the phone company, the owner of the information. He cited *Dirks v. SEC,* 463 U.S. 646 (1983), one of the Supreme Court's insider trading cases, in support of this assertion. The district court rejected his argument, distinguishing *Dirks* on the ground that in that case the defendant "c[a]me upon information *lawfully*" and then breached a fiduciary duty by trading without making required disclosure, while in the case then before it the defendant had participated in a scheme to fraudulently obtain the information in the first place. *Riggs*, 739 F. Supp. at 419 (original emphasis). This analysis applies equally to Dorozhko.

CONCLUSION

For the foregoing reasons, the district court's denial of a preliminary injunction and its decision to vacate the prejudgment asset freeze should be reversed.

Respectfully submitted.

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BRIAN G. CARTWRIGHT
General Counsel

ANDREW N. VOLLMER
Deputy General Counsel

JACOB H. STILLMAN
Solicitor

MARK PENNINGTON
Assistant General Counsel

DAVID LISITZA
Attorney

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-8010
(202) 551-5015 (Lisitza)

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Pursuant to Fed. R. App. P. 32(a)(7)(C)

I hereby certify that, pursuant to Fed. R. App. P. 32(a)(7)(C), the attached brief is proportionately spaced, has a typeface of 14 points or more, and contains 10,884 words.

Dated: May 6, 2008

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David Lisitza
Securities and Exchange Commission
100 F St., N.E.
Washington, D.C. 20549-8010
May 5, 2008
(202) 551-5015

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500 Pearl Street
New York, NY 10007

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Charles A. Ross, Esq.
Christopher L. Padurano, Esq.
Charles A. Ross & Associates
111 Broadway
Suite 1401
New York, NY 10006
cross@carossassoc.com; cpadurano@carossassoc.com

Dated: May 6, 2008

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David Lisitza