No. 98-643

In the Supreme Court of the United States

OCTOBER TERM, 1998

STEVEN R. JAKUBOWSKI, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT*

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether a misrepresentation, which induces the sale of securities but does not pertain to the securities themselves or the consideration offered in exchange for the securities, is made "in connection with the purchase or sale" of the securities for purposes of establishing liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 71a-86a) is reported at 150 F.3d 675. The opinion and order of the district court denying defendant's motion to dismiss (Pet. App. 1a-32a) is reported at 912 F. Supp. 1073. The district court's opinion and order granting plaintiff's motion for summary judgment (Pet. App. 33a-57a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on July 16, 1998. The petition for a writ of certiorari was filed on October 14, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

During 1991 and 1992, petitioner, an associate in the law firm of Skadden Arps Slate Meagher & Flom, engaged in a fraudulent scheme to buy the stock of savings and loan institutions (S&Ls) that he was not eligible to purchase by submitting orders in the names of deposit account holders who were. In this civil enforcement action brought by respondent Securities and Exchange Commission (SEC or Commission), the court of appeals affirmed the district court's entry of summary judgment against petitioner for violating the anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, a rule that the SEC has promulgated to implement the statutory provision, which it is charged to administer.

1. Under regulations issued by the Office of Thrift Supervision (OTS), federally chartered S&Ls are permitted to convert from mutual to stock ownership and to sell stock in connection with the conversion. Deposit account holders of converting S&Ls are given subscription rights to purchase conversion stock before any is offered to the general public. Only those securities remaining after the close of the subscription offering may be offered to the public. 12 C.F.R. 563b.3(c)(2), (5) and (6). In order to be eligible for subscription rights, an account holder must have maintained an account with a specified minimum balance for a specified period of time before the S&L's board of directors adopted the conversion plan. 12 C.F.R. 563b.2(a)(15), 563b.3(c)(14). OTS regulations also prohibit transfer of subscription rights or the underlying conversion stock prior to consummation of the conversion and require notice of that

restriction on stock order forms. 12 C.F.R. 563b.3(i)(1), 563.b.7(g)(4)(ix).

The regulations prevent dilution of the ownership interests of long-term depositors and prevent "persons who get wind of the plan from granting themselves priority in the purchase of stock by enlarging their accounts or opening new ones." *Ordower* v. *OTS*, 999 F.2d 1183, 1185-1186 (7th Cir. 1993). During 1991 and 1992, the stock of newly converted institutions routinely increased in price upon the opening of public trading. Account holders who exercised their subscription rights could therefore usually earn a quick profit by immediately reselling their shares to the public. See *id.* at 1185.

2. As non-account holders, petitioner and his business associate Frank Hart were ineligible to purchase conversion stock. Pet. App. 3a, 5a. To circumvent the eligibility requirement and to capture the profits that OTS regulations intended to confine to account holders, petitioner (initially at Hart's request and later on his own initiative) located eligible account holders and offered them a percentage of profits from sale of the stock in exchange for use of their subscription rights. *Id.* at 34a-40a, 75a-76a. Petitioner prepared subscription forms in the names of the account holders, specified on the forms that the stock certificates be sent to him at his law firm, and had the account holders sign the forms. *Id.* at 35a-39a, 75a.

Between May 1991 and March 1992, petitioner submitted twelve stock order forms to four savings and loan associations. Pet App. 34a-40a. Hart (and, in one instance, a friend of petitioner's) furnished the funds needed to exercise the subscription rights. *Id.* at 35a-39a, 75a. In one conversion, petitioner placed an order for 100,000 shares at a total cost of $1,127,000. *Id.* at

39a. For his participation in the scheme, petitioner received a percentage of the profits when Hart sold the stock. *Id.* at 75a-76a.

As required by OTS regulations, the subscription forms that petitioner filled out prominently stated that the account holder's subscription rights were non-transferable. Pet. App. 75a-76a. Moreover, the forms required the account holders to certify that they had not entered into any agreement to transfer either the subscription rights or the shares they were ordering. *Id.* at 5a-6a, 77a. The certifications on the forms petitioner filled out were false. *Id.* at 77a.

At least two of the applications petitioner submitted were questioned by the S&Ls. Pet. App. 38a, 51a-52a, 76a. S&L officers warned the account holders in whose names the orders had been submitted that they were prohibited from selling their subscription rights. *Id.* at 76a. When the account holders related the warnings to petitioner, he did not withdraw the orders. *Id.* at 40a. Petitioner thereafter created and backdated false loan documents purporting to show loans extended by Hart to the account holders. *Id.* at 76a, 85a-86a.

In all, petitioner and Hart used account holders' subscription rights to purchase 172,050 shares of stock in four different conversions for a total purchase price of almost $2 million. Pet. App. 7a. Petitioner received $51,500 as his share of the profits. *Id.* at 72a. Because there was only a limited amount of conversion stock issued by each savings and loan and the offerings were oversubscribed, some account holders were not permitted to buy as much stock as they had ordered. *Id.* at 4a, 6a-7a. Thus, petitioner's fraudulent purchase of $2 million of conversion stock for himself and Hart deprived legitimate subscribers of the opportunity to purchase and profit from the sale of stock they otherwise would have been allotted.

3. a. After denying petitioner's motion to dismiss the complaint for failure to state a claim, Pet. App. 1a-32a, the district court granted the Commission's motion for summary judgment, *id.* at 33a-57a. The court found that petitioner had raised no genuine issue of material fact with regard to any of the elements of the Commission's claims under Section 10(b) and Rule 10b-5. *Id.* at 45a.

The court rejected petitioner's argument that the requirement of Section 10(b) and Rule 10b-5 that the fraud be "in connection with the purchase or sale of any security" was not met because his deception did not relate to the value of the securities. Pet. App. 52a. That requirement was met, the court found, because petitioner's concealment of the purchasers' identities was the very means by which petitioner and his associates succeeded in purchasing securities that they were legally prohibited from purchasing. *Ibid.* (incorporating reasoning of opinion denying motion to dismiss, *id.* at 24a-29a).

The district court therefore entered final judgment against petitioner. The court permanently enjoined petitioner from further violations of Section 10(b) and Rule 10b-5, ordered him to disgorge illegal profits in the amount of $51,500 and to pay prejudgment interest of $26,922, and imposed a civil penalty of $51,500. Pet. App. 67a-70a.

b. The court of appeals affirmed. Pet. App. 71a-86a. As had the district court, the Seventh Circuit rejected petitioner's argument that his misrepresentations were not in connection with the purchase or sale of a security. *Id.* at 78a. The court explained:

> Jakubowski made his statements directly to the issuer of securities, in order to induce the issuer to accept his offer to buy. The offer was accepted and the shares issued. How could there be a closer "connection" between statements and "the purchase or sale of any security"?

Ibid. The court of appeals explained that its decision was not inconsistent with the court's earlier decision in *Gurwara* v. *LymphoMed, Inc.*, 937 F.2d 380 (7th Cir. 1991), because in that case, unlike this one, there was no purchase or sale of the securities at issue. Pet. App. 78a-79a. The court further noted that petitioner's argument that a misrepresentation must concern the value of a security in order to violate Section 10(b) and Rule 10b-5 was inconsistent with this Court's decisions in *United States* v. *O'Hagan*, 117 S.Ct. 2199 (1997), and *United States* v. *Naftalin*, 441 U.S. 768 (1979), neither of which involved such a misrepresentation. Pet. App. 79a-80a.[1]

ARGUMENT

The court of appeals correctly held that petitioner's misrepresentations were made in connection with the purchase or sale of securities. That decision does not conflict with the decision of any other court of appeals. This Court's review is therefore not warranted.

1. The Court has described Section 10(b) as "a 'catchall' clause to enable the Commission to 'deal with new manipulative (or cunning) devices.'" *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 203 (1976); accord

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[1] The court of appeals also rejected petitioner's contentions that his misrepresentations were not material and that he did not possess the requisite scienter. Pet App. 82a-86a. Petitioner has not renewed those challenges before this Court.

Herman & MacLean v. *Huddleston*, 459 U.S. 375, 386-387 (1983); *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174 (1994). The statute and rule "prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11 n.7 (1971) (quoting *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). In an enforcement action brought under Section 10(b) and Rule 10b-5, the Commission need establish only that, "in connection with the purchase or sale of a security the defendant, acting with scienter, made a material misrepresentation (or a material omission if the defendant had a duty to speak) or used a fraudulent device." *SEC* v. *First Jersey Securities, Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996), cert. denied, 118 S. Ct. 57 (1997).[2]

Petitioner nevertheless attempts to limit the scope of Section 10(b) and Rule 10b-5 by reading into the statute and rule a requirement that is not there. Petitioner contends (Pet. 3-4, 10-13, 17) that his misrepresentations were not "in connection with the purchase or sale of any security" within the meaning of Section 10(b) and Rule 10b-5 because they did not relate to the securities themselves or the consideration paid for the securities. At times he appears to go further and to argue (Pet. 7, 9, 12) that the misrepresentation must relate to the

[2] Unlike a private plaintiff seeking to recover damages in a Section 10(b) action, the Commission is not required to show either reliance on the misrepresentation or injury. *SEC* v. *Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993); *SEC* v. *Blavin*, 760 F.2d 706, 711 (6th Cir. 1985).

value of the securities or consideration. But the statute and the rule contain no such restrictions.

By their terms, Section 10(b) and Rule 10b-5 apply to any fraud occurring "in connection with the purchase or sale of any security," or, as this Court paraphrased the requirement in *Bankers Life*, fraud "touching" the purchase or sale of a security. 404 U.S. at 12-13. The language should be given its plain meaning: The deception need only have some relationship or nexus to a securities transaction.

The courts of appeals have consistently given the "in connection with" requirement that plain meaning. For example, in *Rand* v. *Anaconda-Ericsson*, 794 F.2d 843, 847, cert. denied, 479 U.S. 987 (1986), the Second Circuit stated that the "in connection with" language requires only that the misrepresentations "have some direct pertinence to a securities transaction." Similarly, in *SEC* v. *Drysdale Securities Corp.*, 785 F.2d 38, 42-43 (2d Cir.), cert. denied, 476 U.S. 1171 (1986), the court held that the "in connection with" requirement was met when "securities were transferred as a direct result" of the misrepresentation. See also *Abrams* v. *Oppenheimer Government Securities, Inc.*, 737 F.2d 582, 593 (7th Cir. 1984) ("the 'in connection with' requirement amounts to some nexus but not necessarily a direct and close relationship"); *Brown* v. *Ivie*, 661 F.2d 62, 65 (5th Cir. 1981) ("'in connection with' is to be flexibly applied but requires that there be a nexus between the defendant's fraud and the securities 'sale'").

There is no requirement that the fraud concern an aspect of the security itself, such as its value, or the consideration paid for it. "Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the 'investment value' of securities, and, indeed, it is established that a 10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value.'" *A. T. Brod & Co.*, 375 F.2d at 396-397. In short, the "in connection with" language of Section 10(b) and Rule 10b-5 imposes a requirement of a nexus between the deception and a securities transaction, not a restriction on the subject matter of a fraudulent misrepresentation or omission.

This Court has held actionable under Section 10(b) fraud that concerns neither the value of the securities nor the amount of consideration paid for them. Recently, in *O'Hagan*, 117 S. Ct. at 2209, the Court held that the "in connection with" requirement was met because a misrepresentation of loyalty and confidentiality, made to a nonparticipant in the defendant's subsequent securities transactions, allowed the defendant to obtain confidential information that he used to purchase stock in a company targeted for takeover. The misrepresentation in *O'Hagan* was "feigning fidelity to the source of the information." *Ibid.* Thus, contrary to petitioner's contention (Pet. 18.), the misrepresentation in *O'Hagan* did not relate to the price of the securities.

In *Bankers Life*, 404 U.S. at 9-10, this Court found the "in connection with" requirement met even though "the full market price was paid for" the securities sold, because "the seller [corporation] was duped into believing that it, the seller, would receive the proceeds" when, in fact, the defendant corporate insiders misappropriated the proceeds. That misrepresentation thus concerned the identity of the entity that would receive the proceeds of the sale of securities rather than the value of the securities sold or the consideration paid. Finally, in *Naftalin*, *supra*, the Court held that the defendant's misrepresentation that he owned the stock he sold when in fact he sold it "short" violated Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), a provision analogous to Section 10(b) that prohibits fraud "in the offer or sale" of a security.

The courts of appeals have repeatedly held that Section 10(b) applies to fraud that does not involve misrepresentations about the securities themselves or the consideration paid for them. In *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705, 707, cert. denied, 449 U.S. 1011 (1980), the Second Circuit found that a brokerage firm trainee's misrepresentation that he was an experienced stockbroker and "portfolio management specialist" was actionable under Section 10(b) because the "misstatements of his status not only induced the purchase of the securities involved but their retention as investments as well." The court stated that limiting coverage to misrepresentations relating to the value of securities "would be too accommodative of many common types of fraud, such as the misrepresentation of a collateral fact that induces a transaction." *Id.* at 710 n.3.

Similarly, other courts of appeals have interpreted the "in connection with" clause to require only a nexus with a securities transaction and not a misrepresentation about the securities involved or the consideration paid. For example, in *Brown*, *supra*, the Fifth Circuit held that the "in connection with" requirement was met because the defendants' false representation about insurance requirements induced the plaintiff to sign an agreement that he would sell his stock at book value if he was no longer employed by the company, 661 F.2d at 64-65. The misrepresentation in the case concerned the reason for signing the agreement but did not concern the characteristics of the stock or the price to be paid. See *id.* at 64 & n.3. And, in *Angelastro* v.

Prudential-Bache Securities, Inc., 764 F.2d 939, 944-945, cert. denied, 474 U.S. 935 (1985), the Third Circuit held that a broker-dealer's failure to disclose the interest rates on a margin account was actionable under Section 10(b) and Rule 10b-5 even though it did "not affect the investment value of a particular security," because it "induced [the plaintiff] to purchase certain securities to her financial detriment."

If the "in connection with" clause were construed as petitioner advocates, the protection that Congress provided investors through Section 10(b) would be unduly limited. Investors would be unprotected in situations like those described above, which the courts have long regarded as covered by the statute. The curtailment of protection would be particularly pronounced in the broker-dealer context, in which fraud on customers often involves misrepresentations about the qualifications of salespersons, the risks of margin trading, the qualifications of the brokerage firm, or similar matters that do not pertain to the securities bought or sold or the consideration paid for those securities. See, *e.g.*, *Marbury Management*, 629 F.2d at 707; *Arrington* v. *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 651 F.2d 615, 619 (9th Cir. 1981) (misrepresentation of risks of buying securities on margin); *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 812-813 (2d Cir. 1975) (misrepresentations about a financial adviser's performance).[3]

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[3] If there were any question about the proper interpretation of Section 10(b) or Rule 10b-5, the Court should defer to the reasonable interpretation of the SEC, which administers the statute and promulgated the rule. See *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-844 (1984); *Thomas Jefferson Univ.* v. *Shalala*, 512 U.S. 504, 512 (1994).

2. Contrary to petitioner's contention (Pet. 10-15), there is no conflict among the courts of appeals on the issue petitioner presents.[4] In this case, petitioner's misrepresentations had a particularly close nexus with securities transactions—they directly induced those transactions. In contrast, any misrepresentations in the cases on which petitioner relies did not have that nexus.

In *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984), upon which petitioner principally relies (Pet. 11-12, 15), the misrepresentation (that the borrower was solvent) induced not a transfer of securities but a loan evidenced by notes that the court held (726 F.2d at 936-939) were not securities. The loan was secured by the pledge of stock. The court agreed that the pledge was a purchase or sale of securities but held that the misrepresentation was in connection with the loan, not the pledge, which "was merely an incident in a transaction not otherwise involving the purchase or sale of securities." *Id.* at 944 n.24. The court explained that the "Act and Rule impose liability for a proscribed act in connection with the purchase or sale of a security; it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of a security is a part." *Id.* at 943. Accordingly, although the court stated (*ibid.*) that it was deciding in the negative the question whether misrepresentations or omissions "not pertaining to the securities themselves" can form the basis of a violation of Section 10(b), that was not the holding of the case. Rather, the court held only that the misrepresentations must pertain to the securities

[4] Petitioner's other reasons why the Court should grant certiorari (Pet. 15-17) all depend on the incorrect premise that there is a conflict among the courts of appeals.

transaction itself, not to a different transaction to which the securities transaction is related.[5]

The Second Circuit has made clear in subsequent decisions that *Chemical Bank* did not hold that the "in connection with" requirement restricts the subject matter of the misrepresentations that are actionable under Section 10(b). That court explained in *Drysdale Securities Corp.*, 785 F.2d at 42-43, that "in *Chemical Bank* the direct result of the misrepresentations was a loan and not a securities transfer," but that where, as in *Drysdale*, "securities *were* transferred as a direct result of the misrepresentation" (emphasis supplied), the "in connection with" requirement was met. Further, in *Rand*, 794 F.2d at 847, the Second Circuit emphasized that "none of the alleged misrepresentations [in *Chemical Bank*] pertained to the pledged securities and * * * the incidental involvement of securities as collateral did not by itself implicate the anti-fraud provisions of the federal securities laws." Although the court held that there was no Section 10(b) liability because there was no securities transaction, it described the "in connection with" language of Section 10(b) as requiring only that the "misrepresentations

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[5] Further, *Chemical Bank* was a private action in which the plaintiff, unlike the Commission in its enforcement actions, see note 2, *supra*, must show that it relied on the misrepresentation and that damage resulted from that reliance (elements that the Second Circuit refers to as "transaction causation" and "loss causation"). The language in the *Chemical Bank* decision that, according to petitioner (Pet. 11-12), holds that only misrepresentations about the security are actionable under Section 10(b), read in context, actually pertains to the elements of reliance and injury. See *Chemical Bank*, 726 F.2d at 943 n.23. As petitioner observes (Pet. 16), in private actions those elements may be closely related to—or even confused with—the "in connection with" requirement.

* * * have *some direct pertinence to a securities transaction*." *Ibid*. (emphasis supplied).

In *Saxe* v. *E.F. Hutton & Co.*, 789 F.2d 105, 109 (2d Cir. 1986), which petitioner also contends conflicts with the decision in this case (Pet. 12), the alleged misrepresentations concerned a commodities firm with which the plaintiff opened an account to invest the proceeds from the sale of his securities. The court explained that "the link between the sale of those securities and the opening of the commodities account was too tenuous to satisfy the 'in connection with' requirement of Rule 10b-5," because the plaintiff had already decided to sell his securities *before* the misrepresentations. *Id*. at 108-109. Thus, unlike in this case, the misrepresentations did not induce a sale of securities. Notably, the court held that the plaintiff had stated a claim under the antifraud provisions of the Commodity Exchange Act, which requires deception "in connection with" commodities transactions, because the misrepresentations induced him to open the commodities account. *Id*. at 109.

In *Hunt* v. *Robinson*, 852 F.2d 786, 787 (4th Cir. 1988), also cited by petitioner (Pet. 3, 13, 17), the defendants refused to transfer company stock to the plaintiff as required by his employment contract. In finding no "causal connection" between the allegedly fraudulent refusal to transfer the stock and any actual sale of stock, the Fourth Circuit stated that a state law claim of "fraudulent nonconveyance of stock" is "not transformed into a federal claim simply because the object of the bargain was shares of stock." 852 F.2d at 787.

Finally, petitioner mistakenly contends (Pet. 4, 8-9, 13) that the decision in this case conflicts with the Seventh Circuit's earlier decision in *Gurwara*, *supra*.

Any such conflict would not warrant this Court's review. See *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957). In any event, as the court of appeals explained in this case (Pet. App. 79a), the plaintiff in *Gurwara* had no cause of action because there was no purchase or sale of the stock of the company that employed him, and that stock was "the 'security' on which his 10(b) action was based" (937 F.2d at 382 n.2).[6] Here, of course, petitioner's misrepresentations actually induced sales of securities.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1998

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[6] In *Gurwara*, the employer's false promise not to revoke the employee's stock option rights had induced the employee to take short-term disability leave. The court expressly declined to consider whether the employee "might have sued successfully under section 10(b) for misrepresentations in connection with his *option contract*." 937 F.2d at 382 n.2.