NOTES

PLEADING AROUND THE PRIVATE SECURITIES LITIGATION REFORM ACT: REEVALUATING THE PLEADING REQUIREMENTS FOR MARKET MANIPULATION CLAIMS

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I. INTRODUCTION

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA") to address the serious flaws in the private securities litigation system. Courts, Congress, and many commentators agreed that the chief evil plaguing the system was strike suits, suits “based on no valid claim, brought either for nuisance value or as leverage to obtain

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5. See, e.g., Alexander, supra note 2, at 524–57.
a favorable or inflated settlement.” Strike suits prevailed in private securities claims because, irrespective of the merits of the claim, it was usually less costly for defendants to settle than fight the allegations. Plaintiffs’ attorneys realized that defendants would settle and took advantage of the situation, sometimes filing claims based on bad news rather than evidence of wrongdoing. Congress stepped in to put an end to these abusive strike suits by enacting the PSLRA, which, among other things, raised the pleading standards for private securities claims, stopped plaintiffs from abusing the discovery process to force settlements, and made the threat of sanctions under Federal Rule of Civil Procedure 11 (“Rule 11”) more imposing.

In an attempt to avoid the PSLRA, plaintiffs began filing their securities claims in state courts. The shift to state courts undermined the PSLRA’s goal of deterring strike suits, because the safeguards of the PSLRA only applied to federal claims. In response, Congress passed the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) to stop the movement to state courts. The SLUSA preempted state law causes of action for securities fraud and market manipulation and made securities class actions brought in state courts removable to federal courts. Thus, Congress slammed shut the state court back door.

In one respect, however, a back door for securities strike suits remains open. Market manipulation claims were affected to a lesser extent by the PSLRA’s heightened pleading requirements and, therefore, are still predominately governed by Federal Rule of Civil Procedure 9(b) (“Rule 9(b)”). In interpreting the pleading standards under Rule 9(b), courts have adopted watered-down pleading requirements that fail to appreciate the danger of securities strike suits that Congress recognized. Even where the governing pleading rules are the same for fraud and manipulation claims,
courts have distinguished manipulation from fraud in ways that further lessen plaintiffs’ pleading burden for manipulation actions. For example, some courts have held that a successfully pled manipulation claim is sufficient, by itself, to uphold a fraud claim, while other courts have held that the heightened pleading requirements for fraud are inapplicable where misrepresentations or omissions are only a part of a larger scheme. Thus, plaintiffs’ attorneys have attempted, albeit unsuccessfully, to exploit these softer pleading standards for market manipulation by dressing up fraud claims as manipulation claims. Despite these early failures, however, the pleading requirements for market manipulation make it a much more attractive basis for a strike suit and, in some instances, undermine the provisions of the PSLRA. This Note analyzes the present pleading standards for market manipulation claims and the problems with those standards. Part II provides a brief description of market manipulation and the statutory basis for manipulation suits. Part III looks at the problems that existed in the private securities litigation system prior to the PSLRA and the measures Congress enacted to correct those problems. Part IV begins with an examination of the federal pleading rules that apply to market manipulation claims. It then narrows its analysis by specifically exploring how courts have applied Rule 9(b) to market manipulation actions. Part V analyzes the problems with the present applications of Rule 9(b) to market manipulation claims, arguing that the present interpretations fail to consider the danger of strike suits in securities claims and, in some cases, undercut the PSLRA. Finally, Part VI proposes two solutions to resolve the current problems with the pleading requirements for market manipulation. First, it advances a judicial solution, which argues for courts to adopt a flexible interpretation of Rule 9(b) that considers all three purposes of the rule’s “particularity” requirement. Second, it proposes a legislative solution, which mirrors the basic proposal advanced by the judicial solution but would involve a congressional amendment to the PSLRA.

II. MARKET MANIPULATION

The purpose of this Section is to provide background on market manipulation. First, market manipulation is generally described and illustrated with examples of a few of the more notable types of market manipulation.
manipulation schemes. Second, a brief overview is provided of the relevant statutory law that prohibits manipulation and how civil liability is imposed for violating those laws.

Market manipulation is the practice of artificially raising or depressing a security’s price in order to profit off the investing public’s predictable reaction to the price change. Thus, “the gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators.” In the early decades of the twentieth century, manipulation generally took one of several forms: wash sales, matched orders, and touting.

A wash sale is a transaction in which an individual is both the buyer and the seller. A matched order is a transaction in which a buyer and a seller, working in collusion, submit simultaneous purchase and sale orders for the same amount of shares. The purpose of wash sales and matched orders was to generate a buzz about a security; the investing public would see both the change in the security price as well as the high trading volume as signs that the stock was going somewhere. Touting is the practice of making misleading statements about a security, with the intent of inducing others to purchase or sell the security. Again, the purpose of touting was to help generate a buzz about a security by encouraging others to jump into the market. Market pools, or groups of market manipulators, generally employed these three practices in conjunction to drive the price of a security up so that they could unload their holdings at an inflated price. Then, when the price fell because the manipulation had ceased, they would sell the security short and profit on its fall as well.

22. See Gurary v. Winehouse, 190 F.3d 37, 45 (2d Cir. 1999).
23. Id.
26. See id.
27. See id. at 845 (quoting Comment, Market Manipulation and the Securities Exchange Act, 46 YALE L.J. 624, 626–28 (1937)).
28. See id.
29. See id.
Accordingly, market manipulation was one of the principal evils targeted by the Securities Exchange Act of 1934 ("1934 Act"). Section 9 of the 1934 Act broadly prohibits manipulation of securities markets.\(^\text{31}\) It is, however, limited to manipulation that occurs on national securities exchanges.\(^\text{32}\) Section 9(a)(1) prohibits wash sales\(^\text{33}\) and matched orders\(^\text{34}\) made "for the purpose of creating a false or misleading appearance of active trading."\(^\text{35}\) Similarly, Section 9(a)(3)–(5) "contains a series of prohibitions against manipulation . . . by false statements, rumors, or paid touts."\(^\text{36}\) Section 9(a)(2) prohibits "effect[ing], alone or with one or more other persons, a series of transactions in any security registered on a national . . . exchange . . . [which] creat[es] actual or apparent active trading . . . or rais[es] or depress[es] the price . . . for the purpose of inducing the purchase or sale of such security by others."\(^\text{37}\) This provision, with its broad language, was intended "to outlaw not only pool operations, but ‘every other device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage.'"\(^\text{38}\) Finally, Section 9(e) imposes personal liability on anyone who commits a willful violation.\(^\text{39}\)

Section 10(b) of the 1934 Act has also been utilized to prohibit market manipulation.\(^\text{40}\) Section 10(b) makes it unlawful "[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 such rules and regulations as the Commission may prescribe as necessary."\(^\text{41}\) Pursuant to
that rule-making power, the Securities Exchange Commission promulgated Rule 10b-5, which reads:

It shall be unlawful . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o 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) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . .

Although Section 10(b) and Rule 10b-5 fail to mention whether civil liability may be imposed on violators, the Court has recognized such a remedy.

Market manipulation has generally been held to violate the provisions in Rule 10b-5(a) and Rule 10b-5(c). Under Rule 10b-5, courts have construed the term manipulation broadly in order to further the remedial purposes of the 1934 Act. This is because courts have long recognized that manipulative devices are limited only by the imagination of potential wrongdoers. Thus, Section 10(b) and Rule 10b-5 provide an additional basis for imposing liability on manipulators. Although Rule 10b-5 was originally invoked only in cases where proving a purpose to induce the purchase or sale of a security was difficult or impossible, or where the security involved was not traded over a national exchange, it now appears to be the claim of choice in securities class actions.

To prevail in a market manipulation claim under Rule 10b-5, plaintiffs must establish that “(1) they were injured [that is, loss causation]; (2) in connection with the purchase or sale of securities; (3) by relying on a

42. 17 C.F.R. § 240.10b-5 (2003).
46. “Washing, matching, jumpinig, capping, pegging, churning, pooling, ramping, marking, and warehousing are some of the more well-known forms of market manipulation that the law prohibits.” In re Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 325 n.45 (S.D.N.Y. 2003).
47. See, e.g., United States v. Mulheren, 938 F.2d 364, 368 (2d Cir. 1991).
48. See supra note 32.
49. See Phillips & Miller, supra note 2, at 1010. All of the cases discussed infra involve claims brought under Section 10(b) and Rule 10b-5.
market for securities; (4) ... artificially affected by defendant’s ... manipulative conduct; and (5) the defendant[s acted with] scienter.”

III. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Part provides background on the PSLRA. First it looks at the problems that existed in the private securities litigation system that prompted Congress to enact the PSLRA. It then outlines a few of the provisions that Congress implemented in order to address those problems.

The procedural rules in private securities claims were a major factor in enabling strike suits. First, even under the alleged heightened pleading rules, plaintiffs could claim that defendants violated the securities laws without any factual basis for their assertions. Additionally, defendants were unable to get these claims dismissed because, under Federal Rule of Civil Procedure 12(b)(6) (“Rule 12(b)(6)”), a complaint could only be dismissed if “it appear[ed] beyond doubt that the plaintiff [could] prove no set of facts in support of his claim which would entitle him to relief.” Thus, plaintiffs’ attorneys realized that the truth of their allegations was irrelevant so long as the complaint was sufficient to survive a motion to dismiss. Concurrently, they would use the liberal discovery rules to both conduct fishing expeditions in the hope they might actually discover a factual basis for their claims and to impose heavy costs on defendants in order to leverage a settlement. Additionally, plaintiffs’ attorneys had good reason to engage in extensive discovery, since, under the lodestar method, their fee from a settlement was tied to the number of hours they worked. Finally, courts rarely used their discretion under Rule 11 to sanction attorneys for filing frivolous claims.

50. In re Blech Sec. Litig., 961 F. Supp. 569, 582 (S.D.N.Y. 1997) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)). See In re Enron, 235 F. Supp. 2d at 580. To properly allege securities fraud, in contrast, plaintiffs must establish (1) defendant made a misstatement or omission of material fact, (2) in connection with the purchase or sale of a security, (3) with scienter, (4) on which plaintiff reasonably relied, and (5) the misrepresentation caused plaintiff’s loss (loss causation). E.g., Binder v. Gillespie, 184 F.3d 1059, 1063 (9th Cir. 1999).
51. See, e.g., Phillips & Miller, supra note 2, at 1033–35.
53. See Phillips & Miller, supra note 2, at 1014.
54. “Under the lodestar method . . . the court determines the fee by multiplying the number of hours worked by a reasonable or customary hourly rate.” Alexander, supra note 2, at 538. Thus the more discovery plaintiffs’ attorneys requested, the higher their compensation from the settlement.
55. See id. at 537–43.
56. See, e.g., Phillips & Miller, supra note 2, at 1014.
In addition, strike suits were prevalent in securities claims because settlement was the rational decision for both sides. In class action claims, defendants often faced enormous liability; an adverse judgment could devastate an individual or a corporation. Furthermore, the costs of discovery were substantial and generally fell entirely on the defendants. Additionally, securities class actions burdened corporate defendants by diverting management and resources from their best use. On the other side, the plaintiffs’ attorneys had every reason to settle. They preferred a guaranteed payoff, rather than risk losing at trial and ending up with nothing. Since any fee was contingent upon winning some sort of recovery, they would have to absorb the entire cost of litigation if they lost. Finally, both sides preferred to settle because insurance would cover a settlement; a finding of fraud, in contrast, would usually fall outside of an insurance policy’s coverage.

In sum, plaintiffs’ attorneys routinely filed strike suits because they were highly profitable and entailed few risks. Faced with a potentially lucrative—and virtually certain—settlement, little chance of sanctions, and few procedural barriers, plaintiffs’ attorneys abused the system.

To address the problem with strike suits, Congress enacted the PSLRA, which changed the legal landscape for private securities claims. One of the changes was to heighten the pleading requirements for securities claims. The purpose of these requirements was to deter the filing of baseless claims and encourage plaintiffs to investigate the facts beforehand. Section 101(b) of the PSLRA applies to plaintiffs who allege that a defendant “(A) made an untrue statement of a material fact, or (B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.” This language mirrors that used in Rule 10b-5(b).

57. See, e.g., id. at 1037–38.
58. See, e.g., id. at 1037.
59. See, e.g., Alexander, supra note 2, at 548–49.
60. See, e.g., Phillips & Miller, supra note 2, at 1013.
61. See, e.g., Alexander, supra note 2, at 536–37.
62. See, e.g., id. at 543.
63. See, e.g., id. at 550–54.
64. See, e.g., Phillips & Miller, supra note 2, at 1036–38.
66. See Phillips & Miller, supra note 2, at 1041–44.
67. § 78u-4(b)(1).
68. 17 C.F.R. § 240.10b-5(b) (2003) (“It shall be unlawful [t]o make any untrue statement of 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.”).
effectively limiting the scope of section 101(b) to securities fraud claims.\textsuperscript{69} To satisfy section 101(b)’s heightened requirements, plaintiffs must “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement is made on information and belief, the complaint shall state with particularity all the facts on which the belief is formed.”\textsuperscript{70} Thus, plaintiffs are required to either (1) specifically identify a statement that a defendant made and explain why they believe it is fraudulent or (2) allege that they believe a defendant made a fraudulent statement, accompanied by a sufficient factual basis for that belief.

Section 101(b) also heightens the pleading requirements for private securities claims. It reads:

In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.\textsuperscript{71}

For securities claims that require allegations of scienter, therefore, plaintiffs must include a sufficient factual basis to support their assertion that a defendant acted with the necessary state of mind. The purpose of this section is to help curtail strike suits by ensuring that plaintiffs’ allegations are supported.

Section 101(b) also enforces the heightened pleading requirements, ordering courts to dismiss complaints that fail to satisfy its heightened pleading requirements.\textsuperscript{72} The purpose of such a provision was to address the shortcomings of Rule 12(b)(6). Whereas under Rule 12(b)(6) courts were only allowed to dismiss claims for which there appeared to be no set of facts that would entitle plaintiffs to relief, under the PSLRA, courts were ordered to dismiss complaints that simply failed to meet the pleading standards.\textsuperscript{73}

\textsuperscript{70} § 78u-4(b)(1). Allegations made on “information and belief” are those “based on secondhand information that the declarant believes to be true.” BLACK’S LAW DICTIONARY 348 (2d Pocket ed. 2001).
\textsuperscript{71} § 78u-4(b)(2).
\textsuperscript{72} See § 78u-4(b)(3)(A).
\textsuperscript{73} See Phillips & Miller, supra note 2, at 1043–44.
To supplement the heightened pleading requirements, Congress included a mandatory stay on discovery pending any motion to dismiss. The purpose of this provision was to prevent plaintiffs from driving up defendants’ costs in order to leverage a favorable settlement. It also prevented plaintiffs from engaging in fishing expeditions to uncover facts that would support their claims. Thus, defendants that move to dismiss a complaint are relieved from the costs of discovery until the court addresses the sufficiency of the complaint.

In addition, the PSLRA requires courts to make specific findings as to whether or not the parties have complied with Rule 11. If a party fails to comply with Rule 11, then the court is required to impose sanctions on that party. Additionally, the PSLRA creates a rebuttable presumption that the appropriate sanction for a violation of Rule 11 is an award of attorney’s fees and costs incurred by the opposing party. Thus the PSLRA puts “teeth” into the pleading requirements by (1) forcing courts to evaluate whether the parties complied with Rule 11, (2) making sanctions mandatory for Rule 11 violations, and (3) making monetary sanctions the default position.

Overall, Congress’s solution was to implement a series of procedural hurdles that made it more difficult for plaintiffs to bring strike suits. Though the PSLRA does impact the fees plaintiffs’ attorneys would receive from a settlement, the strong incentives to settle securities suits remain in spite of it. Finally, with one exception, which applies exclusively to securities fraud actions, the provisions of the PSLRA apply to market manipulation claims.

74. See § 78u-4(b)(3)(B).
75. See Phillips & Miller, supra note 2, at 1045.
76. See id.
77. See § 78u-4(c)(1).
78. See § 78u-4(c)(2).
79. See § 78u-4(c)(3).
80. See Phillips & Miller, supra note 2, at 1045–48.
82. “Total attorneys’ fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class.” § 78u-4(a)(6).
83. § 78u-4(b)(1).
IV. PLEADING MARKET MANIPULATION: THE PRESENT LANDSCAPE

This Part analyzes the pleading standards for market manipulation claims. First, it provides a brief overview of the applicable federal rules: Federal Rule of Civil Procedure 8(a) ("Rule 8(a)"), Rule (9)(b), and the PSLRA. Next, it focuses on two of the elements unaffected by the PSLRA’s heightened pleading requirements: manipulative conduct and loss causation.

A. GENERAL PLEADING REQUIREMENTS UNDER THE FEDERAL RULES

Rule 8(a) governs the pleading standards for all federal civil claims. It requires plaintiffs to provide “a short and plain statement of the claim showing that the pleader is entitled to relief.”84 Specific factual allegations are unnecessary; conclusory allegations are sufficient to meet Rule 8(a)’s requirements.85 Thus, manipulation claims must first meet the minimal requirements of Rule 8(a).

Furthermore, Rule 9(b) imposes a heightened pleading requirement for specific types of claims.86 It reads: “In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.”87 Since fraud under Rule 9(b) includes market manipulation, the heightened pleading requirements apply.88 Rule 9(b) does not, however, replace the requirements of Rule 8(a); the two must be read together.89 In harmonizing the two rules, Judge Frank Easterbrook wrote that Rule 9(b)’s particularity requirement is satisfied when plaintiffs allege “the who, what, when, where, and how.”90 Rule 9(b)’s pleading requirements may be relaxed, however, when knowledge of a scheme is in the exclusive possession of the defendants.91 In such cases, plaintiffs may

84. FED. R. CIV. P. 8(a).
87. FED. R. CIV. P. 9(b).
89. See, e.g., Schaller Tel. Co. v. Golden Sky Sys., Inc., 298 F.3d 736, 746 (8th Cir. 2002); Ziemba v. Cascade Int’l, Inc., 256 F.3d 1194, 1202 (11th Cir. 2001); Ouaknine v. MacFarlane, 897 F.2d 75, 79 (2d Cir. 1990); Cayman Exploration Co. v. United Gas Pipe Line Co., 873 F.2d 1357, 1362 (10th Cir. 1989).
90. DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990).
91. See, e.g., Neubronner v. Milken, 6 F.3d 666, 672 (9th Cir. 1993).
satisfy Rule 9(b) by generally alleging, on “information and belief,”92 that they believe a defendant engaged in wrongdoing, so long as they include a factual basis for their belief.93

The definition of particularity under Rule 9(b) may differ from case to case.94 This is because the purpose of the particularity requirement is three-fold: (1) to provide defendants with fair notice of the claims against them, (2) to protect defendants’ reputations or goodwill from harm, and (3) to deter strike suits and fishing expeditions.95 In the case of securities class action suits, courts have generally been most concerned with the potential for strike suits and fishing expeditions.96

Finally, market manipulation claims are also subject to the PSLRA’s heightened pleading requirements. Since plaintiffs can only prevail on manipulation claims by establishing that a defendant acted with scienter, section 101(b) applies.97 Therefore, to satisfy the pleading standard for scienter plaintiffs must allege: (1) that a defendant acted with a particular state of mind and (2) facts that strongly support that assertion.98

Thus, manipulation claims are both governed by Rule 9(b) and the PSLRA.99 Rule 9(b) sets forth the pleading requirements for manipulative conduct and loss causation; section 101(b) of the PSLRA governs scienter.100

92 See supra note 70.
93 See, e.g., Neubronner, 6 F.3d at 672.
94 See Guidry v. Bank of LaPlace, 954 F.2d 278, 288 (5th Cir. 1992).
98 Id.
99 Id.
100 Much has been written on the circuit split over both the minimum level of scienter required, compare Novak v. Kasaks, 216 F.3d 300, 307–08 (2d Cir. 2000) (holding recklessness is the minimum level of scienter required), and In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 550 (6th Cir. 1999) (same), with In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 977 (9th Cir. 1999) (holding deliberate recklessness is the minimum level of scienter required), and what facts must be pled to support a strong inference of that level of scienter, compare Novak, 216 F.3d at 307–08 (requiring plaintiffs to allege facts showing motive and opportunity or facts that demonstrate strong circumstantial evidence of conscious misbehavior), with In re Comshare, 183 F.3d at 551 (“[P]laintiffs may meet PSLRA pleading requirements by alleging facts that give rise to a strong inference of reckless behavior.”), and In re Silicon Graphics, 183 F.3d at 983 (“[P]laintiff must state with particularity facts demonstrating deliberate recklessness.”). This split, however, is more form than substance. The Ninth Circuit’s definition of deliberate recklessness is substantially similar to the definition of recklessness used by both the Second and Sixth Circuits. See Novak, 216 F.3d at 308 (“[C]onduct which is highly unreasonable” and which represents an ‘extreme departure from the standards of ordinary care . . . to the
B. APPLICATION OF RULE 9(B) TO MARKET MANIPULATION CLAIMS

This Section analyzes the pleading requirements for two of the elements of market manipulation that were unaffected by the PSLRA’s heightened pleading requirement, and are therefore still governed by Rule 9(b): manipulative conduct and loss causation.

1. Manipulative Conduct

Some courts have permitted broad allegations of the nature, purpose, and effect of a manipulative scheme to satisfy Rule 9(b)’s heightened pleading requirements. In *In re Blech Securities Litigation* ("Blech I"), the Southern District of New York recognized that Rule 9(b) generally requires plaintiffs to “allege the time, place, speaker, and sometimes even the content of the alleged misrepresentation.” It also recognized, however, that “market manipulation claims present circumstances in which the mechanism of [a] scheme is likely to be unknown to the plaintiffs.” Accordingly, it held that plaintiffs’ complaint could satisfy Rule 9(b) if it alleged “the nature, purpose, and effect of the fraudulent conduct and the
roles of the defendants.” Absent, however, was a requirement that the plaintiffs provide any factual basis for their beliefs. So, although plaintiffs alleged a scheme in “broad strokes,” the court held that “at this stage no more can be required to give Defendants fair notice of Plaintiffs’ claims.” Although the court recognized that the purpose of Rule 9(b) was three-fold, it held that the allegations were sufficient because they placed the defendants on notice of the claims. Thus, under Blech I, plaintiffs satisfy Rule 9(b) if they generally allege: (1) the manipulative acts performed, (2) who performed them, and (3) the scheme’s effect on the market.

The following year, in In re Blech Securities Litigation ("Blech II"), the court reaffirmed its nature, purpose, and effect test. It concluded, however, that the nature, purpose, and effect test satisfied all three of Rule 9(b)’s purposes: (1) providing defendants with notice, (2) protecting defendants’ reputations from harm, and (3) deterring strike suits. It reached this conclusion, however, without ever addressing how the nature, purpose, and effect test advanced the latter two goals. Similarly, in In re Initial Public Offering Securities Litigation ("IPO I"), the court followed the nature, purpose, and effect test despite undertaking a detailed analysis of the three-fold purpose of Rule 9(b). Since the plaintiffs had alleged that the defendants carried out a scheme that “had the effect of inflating the price of the Issuer’s common stock above the price that would have otherwise prevailed in a fair and open market,” the court held that the complaint satisfied Rule 9(b). The Blech I nature, purpose, and effect test has also received support from outside of the Second Circuit.

Other Second Circuit district courts have restrictively interpreted the nature, purpose, and effect test. For example, in In re Sterling Foster & Co. Securities Litigation, the court held that the test is not satisfied where the

104. Id.
105. See id. at 1290–92.
106. Id. at 1291.
107. Id. at 1288.
108. See id. at 1291.
109. Id.
111. Id.
112. See id. at 579–80, 583–85.
114. See id. at 325–26.
115. Id. at 389–90.
allegations are of a hypothetical scheme, rather than affirmative allegations of an actual scheme that affected the market. Moreover, in _In re Merrill Lynch & Co. Research Reports Securities Litigation_, Judge Milton Pollack held that manipulation claims based solely on alleged misrepresentations or omissions must comply with the PSLRA’s heightened pleading requirements. The plaintiffs argued that they only needed to satisfy the nature, purpose, and effect test because their claim was for market manipulation, not securities fraud. Judge Pollack rejected the argument, because misstatements and omissions were the only things involved in the alleged scheme. Overall, though, the nature, purpose, and effect test remains the standard for manipulation claims in the Second Circuit.

A different approach to pleading market manipulation is found in _Jones v. Intelli-Check, Inc._ In _Jones_, the court similarly recognized that plaintiffs may have difficulty meeting the demands of Rule 9(b) in market manipulation claims, because the information needed may be “peculiarly within the defendant’s knowledge or control.” The court was willing, therefore, to relax the pleading requirement. To get the benefit of the relaxed standard, however, the plaintiffs had to “allege that the necessary information lies within defendants’ control.” Boilerplate allegations that the information was exclusively within defendant’s possession, however, were insufficient. Rather, the plaintiffs had to provide a factual basis for the belief by “delineat[ing] . . . the nature and scope of [their] efforts to obtain, before filing the complaint, the information needed to

119. See id.
120. See id. at 375–76. See also Schnell v. Conseco, Inc., 43 F. Supp. 2d 438, 448 (S.D.N.Y. 1999) (“Plaintiffs’ allegations of misconduct . . . are largely based on misrepresentations and omissions[, ] . . . [therefore] the heightened pleading standard of the [PSLRA] applies.”). But see _In re Enron_, 235 F. Supp. 2d at 563–65, 570–77 (holding the PSLRA’s heightened pleading requirements are inapplicable to market manipulation claims in which misstatements or omissions are just one part of a larger scheme).
122. Id. (quoting _In re Rockefeller Ctr. Props._, Inc. Sec. Litig., 311 F.3d 198, 216 (3d Cir. 2002)) (quotations omitted).
123. See id. at 628–29.
124. Id. at 629 (quoting Shapiro v. UJB Fin. Corp., 964 F.2d 272, 285 (3d Cir. 1992)) (internal quotations omitted).
125. “Ready-made or all-purpose language that will fit in a variety of documents.” _BLACK’S LAW DICTIONARY_ 72 (2d Pocket ed. 2001). In the securities context, courts routinely use this term to refer to allegations that are generic, conclusory, and lacking any support.
126. _Jones_, 274 F. Supp. 2d at 629.
plead with particularity." Thus, under the Jones test, plaintiffs sufficiently plead manipulative conduct if they (1) allege that information pertaining to the scheme is in the exclusive possession of the defendants and (2) set forth “the extent of their efforts to obtain the information prior to filing their complaint.”

In contrast, the Ninth Circuit appears to follow the traditional information and belief standard for relaxing Rule 9(b)’s heightened pleading requirements. It too holds that Rule 9(b) requires plaintiffs to allege “times, dates, places, benefits received, and other details of the alleged fraudulent activity.” In re Herbalife Securities Litigation (“In re Herbalife”), though not specifically addressing market manipulation, Judge Stephen Wilson noted that the Ninth Circuit similarly relaxed Rule 9(b)’s requirements when the “matters at issue are within the opposing party’s knowledge.” “In such cases, the particularity requirement may be satisfied if the allegations are accompanied by a statement of the facts upon which belief is founded.” Thus, plaintiffs must set forth facts that support their allegations, but because the Ninth Circuit has only addressed relaxed pleading requirements in the securities fraud context, it is unclear what exactly plaintiffs must generally allege with respect to a defendant’s manipulative conduct. In sum, there is only half of a test for market manipulation in the Ninth Circuit.

2. Loss Causation

Causation under federal securities laws involves two elements: (1) transaction causation, or reliance, and (2) loss causation. Courts have likened loss causation to the tort concept of proximate cause: plaintiffs must demonstrate that the alleged wrongdoing caused their loss. Though courts had already required plaintiffs to plead and prove loss causation to prevail on market manipulation claims, Congress expressly made it an

127. Id. (quoting Shapiro, 964 F.2d at 285) (internal quotations omitted).
128. Id. (citing Shapiro, 964 F.2d at 285).
129. See Neubronner v. Milken, 6 F.3d 666, 672 (9th Cir. 1993); In re Herbalife Sec. Litig., 1996 U.S. Dist. LEXIS 11484, at *18–*19 (C.D. Cal. 1996).
130. Neubronner, 6 F.3d at 672.
132. Id. (quoting Wool v. Tandem Computers, 818 F.2d 1433, 1439 (9th Cir. 1987)) (internal quotations omitted).
133. See, e.g., Broudo v. Dura Pharmns., Inc., 339 F.3d 933, 937 (9th Cir. 2003); Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95–96 (2d Cir. 2001); Robbins v. Koger Props., Inc., 116 F.3d 1441, 1447 (11th Cir. 1997).
134. See, e.g., Suez Equity, 250 F.3d at 96.
135. See, e.g., Binder v. Gillespie, 184 F.3d 1059, 1065 (9th Cir. 1999).
element of recovery in the PSLRA. Section 101(b) of the PSLRA reads: “In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.” Thus, loss causation is clearly an element of a securities claim.

In the context of securities fraud claims, the circuits are split, however, with respect to the pleading requirements for loss causation. The Eighth and Ninth Circuits hold that allegations of fraud on the market satisfy plaintiffs’ loss causation pleading burden if they can also demonstrate that the price was artificially inflated. Conversely, the Second, Third, and Eleventh Circuits agree that plaintiffs must demonstrate that they bought at an inflated price and then sold when the price was no longer inflated in order to satisfy the loss causation pleading requirement. Yet, in In re Initial Public Offering Securities Litigation (“IPO II”), a district court within the Second Circuit reasoned that since manipulation operates differently than fraud, allegations of artificial inflation, and nothing more, satisfied the loss causation pleading requirement. This subsection, therefore, will focus on three things: (1) the fraud on the market theory, (2) the circuit split over whether allegations of fraud on the market and artificial inflation satisfy the pleading requirement of loss causation in the securities fraud context, and (3) the IPO II court’s rationale as to why manipulation and fraud are distinct.

The Supreme Court formally adopted the fraud on the market theory in Basic, Inc. v. Levinson. The theory provided plaintiffs with a presumption of reliance in cases where defendants made public misrepresentations; this bypassed the requirement that plaintiffs had to show individual reliance on the specific representation and how they would have acted had they known the truth. The Basic Court accepted that

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137. Id. (emphasis added).
138. See, e.g., Suez Equity, 250 F.3d at 95–96.
139. See Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938 (9th Cir. 2003); Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 831–32 (8th Cir. 2003); Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996); In re Control Data Corp. Sec. Litig., 933 F.2d 616, 619–20 (8th Cir. 1991).
143. See id. at 245.
publicly available information is usually incorporated into the price of a security, and therefore, public misrepresentations would similarly be assimilated into the price. Since investors buying or selling securities at the market price do so “in reliance on the integrity of that price,” the court concluded that plaintiffs’ reliance could be presumed because reliance on the market price was equivalent to reliance on the misrepresentation. Thus, plaintiffs were entitled to a presumption of reliance if they alleged and proved that (1) the defendant made public misrepresentations, (2) the misrepresentations were material, (3) the security traded in an efficient market, and (4) the plaintiffs traded the security between the time when the misrepresentation was made and when the truth was disclosed.

The fraud on the market theory has been expanded, however, to include a presumption of loss causation. This is because the efficient market hypothesis, which underlies the fraud on the market theory, presumes that “the price of [a] stock at a given time is the best estimate of what the price will be in the future.” Looked at another way, public misrepresentations will presumably affect the price of a security. Since the efficient market hypothesis leads to the conclusion that a public misrepresentation will affect the price, courts will presume loss causation.

In securities fraud cases, the Eighth and Ninth Circuit presume loss causation if plaintiffs allege fraud on the market and that they traded the security at an artificially affected price. In Knapp v. Ernst & Whinney, the Ninth Circuit held that loss causation could be presumed in a fraud on the market case if plaintiffs simply alleged that they purchased the security at an inflated price. It rejected the defendants’ argument that the

144. Id. at 247.
145. Id.
146. Id. at 248 n.27.
149. See Fischel, supra note 147, at 910–11.
151. See Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003); Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 831–32 (8th Cir. 2003); Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996); In re Control Data Corp. Sec. Litig., 933 F.2d 616, 619–20 (8th Cir. 1991).
152. See Knapp, 90 F.3d at 1438. But see Jeffrey L. Oldham, Comment, Taking “Efficient Markets” out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act, 97 NW. U. L. REV. 995, 1025–32 (2003) (arguing that the PSLRA evinces Congress’s intent that
plaintiffs, who bought after the misrepresentation but sold before the truth was revealed, failed to establish loss causation.\textsuperscript{153} It reasoned that plaintiffs who sold before defendants issued a corrective statement might nonetheless suffer injury from the misrepresentation, because the market could slowly dissipate the inflationary effect, thereby causing harm to the plaintiffs.\textsuperscript{154} Similarly, in \textit{Gebhardt v. ConAgra Foods, Inc.}, the Eighth Circuit concluded that “paying more for something than it is worth is damaging.”\textsuperscript{155} These courts seem to reason that since the loss is measured at the time of the purchase or sale, the harm is suffered as soon as the trade is made irrespective of whether or not the truth is subsequently revealed.\textsuperscript{156} Thus, plaintiffs need only allege and support with facts that they purchased or sold at an artificially inflated or deflated price.\textsuperscript{157}

In contrast, the Second, Third, and Eleventh Circuits all hold that allegations of fraud on the market do not entitle securities fraud plaintiffs to a presumption of loss causation.\textsuperscript{158} These Circuits conclude that misrepresentations only harm plaintiffs if they purchase at an inflated price and sell when the price is no longer inflated.\textsuperscript{159} “To plead loss causation, therefore, a plaintiff must allege something more than mere price inflation—something that explains the plaintiff’s loss.”\textsuperscript{160} A corrective statement, for example, coupled with allegations of artificial inflation would suffice to establish loss causation.\textsuperscript{161}

As the \textit{IPO II} court noted, “[s]o long as the amount of inflation is constant, artificial inflation causes no loss for customers who buy \textit{and} sell at inflated prices.”\textsuperscript{162} This approach recognizes that stock prices drop and that a plaintiff’s loss may be attributable to a market decline or a factor

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{153} \textit{See Knapp}, 90 F.3d at 1438.
\item \textsuperscript{154} \textit{Id.} ("Price changes that occur before a corrective statement might still be the \textquoteleft \textquoteleft result of market forces operating on the misrepresentation.\textquoteright \textquoteright" (quoting \textit{Wool v. Tandem Computers, Inc.}, 818 F.2d 1433, 1437 (9th Cir. 1987)).
\item \textsuperscript{155} \textit{Gebhardt}, 335 F.3d at 831. \textit{See also id.} at 831–32 ("If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered a harm.").
\item \textsuperscript{156} \textit{See, e.g., Knapp}, 90 F.3d at 1438.
\item \textsuperscript{157} \textit{See, e.g., Broudo v. Dura Pharms., Inc.}, 339 F.3d 933, 938–39 (9th Cir. 2003).
\item \textsuperscript{158} \textit{See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.}, 343 F.3d 189, 198 (2d Cir. 2003); \textit{Semenenko v. Cendant Corp.}, 223 F.3d 165, 185 (3d Cir. 2000); Robbins v. Koger Props., Inc., 116 F.3d 1441, 1448–49 (11th Cir. 1997).
\item \textsuperscript{159} \textit{See Semerenko}, 223 F.3d at 185.
\item \textsuperscript{160} \textit{In re Initial Pub. Offering Sec. Litig.}, 297 F. Supp. 2d 668, 671 (S.D.N.Y. 2003).
\item \textsuperscript{161} \textit{See Semerenko}, 223 F.3d at 185.
\item \textsuperscript{162} \textit{In re Initial Pub. Offering Sec. Litig.}, 297 F. Supp. 2d at 673.
\end{enumerate}
\end{footnotesize}
other than an alleged misrepresentation. 163 According to the court in IPO II, an inflated price can lead to a loss in two ways: (1) the fraud is revealed and the artificial inflation disappears or (2) ordinary market forces slowly dissipate the full effect of the artificial inflation. 164 It concluded that in either instance, courts should not confer on plaintiffs a presumption of loss causation; plaintiffs must allege a corrective disclosure or event that supports that the artificial inflation was no longer present at the time of sale. 165 Thus, under the IPO II approach, plaintiffs are required to allege both inflation and dissipation to satisfy the pleading requirements for loss causation. 166

Yet, the IPO II court concluded that in market manipulation claims, artificial inflation, standing alone, was sufficient to establish loss causation. Noting that under the efficient market hypothesis a stock’s price reflects all currently available public information, it concluded that fraud claims were distinguishable from manipulation claims. 167 It reasoned that artificial price inflation caused by a misrepresentation would remain incorporated into a security’s price until contrary information became available, whereas inflation caused by manipulation would automatically dissipate once the manipulative conduct ceased because the information available to the market would be the same as before. 168 Accordingly, it concluded that in the case of manipulation, plaintiffs would suffer a loss from the ordinary operation of the market. 169 Under IPO II, therefore, plaintiffs sufficiently plead loss causation if they allege artificial inflation, because the court will presume that the inflation will dissipate.

V. THE PROBLEM WITH THE PRESENT PLEADING STANDARDS

Despite Congress’s recognition that strike suits were a serious problem in securities claims, courts have essentially ignored the goal of deterring strike suits when relaxing the pleading standard of Rule 9(b) for market manipulation claims. 170 Though they are correct in recognizing that plaintiffs alleging manipulative conduct are unlikely to be able to specify

163. See id. at 672–73.
164. See id. at 673.
165. See id. at 672, 674 n.29.
166. But see id. at 675 (holding that deflation need not be established if plaintiffs’ fraud claim is premised on nondisclosure of a market manipulation scheme and the manipulation claim is adequately pled).
167. Id. at 673–75.
168. Id. at 674–75.
169. See id.
170. See infra Part IV.B.1.
the “who, what, when, where, and how,” the relaxed standards permitted by Blech I and Jones to ameliorate this difficulty make it much easier for plaintiffs to bring meritless claims. The Blech I court’s exclusive focus on whether or not the allegations placed the defendants on notice fails to realize that placing a defendant on notice of a claim is relatively straightforward; protecting defendants’ reputations and deterring strike suits require something more than what mere notice will provide. The Blech II and IPO I courts went a step further, announcing that the nature, purpose, and effect test advanced all three purposes of Rule 9(b). Yet neither court addressed how the nature, purpose, and effect test would protect defendants’ reputations or how it would deter strike suits. In Jones, the court concluded that plaintiffs adequately allege manipulative conduct with a boilerplate allegation that the mechanism of the scheme is exclusively within the defendants’ knowledge coupled with a statement of the extent of their investigations. The Jones approach, however, fails to define the extent of the investigation and, more importantly, neglects to address how its standard serves the policy goals of Rule 9(b). While the In re Herbalife pleading standard is on par with that of the PSLRA in requiring plaintiffs to support their allegations with a factual basis, it only provides a hint of what the pleading standard for manipulation might be, since it specifically addressed only the standard for fraud claims. In sum, no court has advanced a pleading standard for manipulative conduct that considers the PSLRA’s objective and all three purposes behind Rule 9(b).

Furthermore, the IPO II pleading standard for loss causation in manipulation claims is lighter than the respective standard for fraud claims even though Rule 9(b) governs both. The IPO II court failed to realize that the same principles that apply to fraud claims also apply to manipulation claims; plaintiffs are not harmed by a manipulative scheme if they purchase after the scheme begins but sell before it has finished, because they will have bought and sold at an inflated price, just like plaintiffs in a fraud action. A scheme will therefore only harm plaintiffs if they trade after the conduct has ceased. The efficient market hypothesis, however, suggests

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171. DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990).
172. See supra text accompanying notes 105–06.
173. In a footnote, the IPO II court appears to have recognized this fact, yet nonetheless held that it was unnecessary for plaintiffs to plead that the alleged scheme had ceased. In re Initial Pub. Offering Sec. Litig., 297 F. Supp. 2d at 675 n.33. It concluded that it was sufficient to require plaintiffs to produce support when the conduct ceased before the defendants had to submit their motion in opposition of class certification. Id. This solution fails to recognize that permitting the claim to proceed, even though only class members purchasing after the conduct ceased would be able to establish loss causation, would end the stay on discovery under the PSLRA. Plaintiffs, therefore, could proceed with
that in an ongoing market manipulation scheme the artificial inflation and
dissipation work against one another since the information available to the
public remains unchanged.\footnote{See Fischel, supra note 147, at 910–11.}
Hence, plaintiffs may suffer a loss although they traded before the scheme ended, because investors that were not
fooled by the scheme worked to slowly dissipate the price of the security.
Yet, operationally, this type of dissipation of a market manipulation claim
is identical to that in a fraud claim in which the misstatement remains
incorporated in the price but the price dissipates due to the natural
operation of the market. Because the \textit{IPO II} court concluded that plaintiffs
in fraud claims are not entitled to a presumption of loss causation if
dissipation due to natural market operation caused them harm, in theory,
the same rule should also apply to manipulation claims. That Congress
coupled with the fact that most of these claims will settle
without courts ruling on the merits\footnote{See, e.g., Alexander, supra note 2, at 524–26; Pertino, supra note 81, at 921–22.}
supports a rule that courts should not
presume loss causation absent allegations that the manipulative conduct
had ended. Thus, the \textit{IPO II} pleading standard for loss causation in
manipulation claims is softer than the respective standard for fraud claims,
although no meaningful distinction between the two exists.

Overall, the present pleading standards for market manipulation leave
open a back door for strike suits, because the prevailing interpretations of
the pleading standards for market manipulation are less stringent than the
respective standards for fraud claims. Whereas the heightened pleading
requirements of the PSLRA apply to the material misstatement or omission
element of a securities fraud claim,\footnote{See supra text accompanying notes 66–69.}
the relaxed interpretations of Rule
\textit{9(b)} govern what plaintiffs must allege to satisfy manipulative conduct.
Additionally, although fraud and manipulation claims are both governed by
Rule \textit{9(b)} with respect to loss causation, they have been distinguished in a
way that makes the pleading standard for manipulation less rigorous.\footnote{See infra Part IV.B.2.}
Plaintiffs’ attorneys have recognized that the pleading requirements for
manipulation are softer than those for fraud; some have even attempted to
pass off fraud claims as manipulation claims in order to “plead around” the

\textit{discovery, reopening the possibility of “fishing expeditions” and leveraged settlements. See supra text
accompanying note 52.}
PSLRA’s heightened pleading requirements. Since deterrence of securities strike suits was a goal of the PSLRA, permitting plaintiffs to file securities class actions under less rigorous pleading standards pursuant to alleged manipulation, as opposed to fraud, seems to undermine that objective.

Furthermore, if the pleading standards for market manipulation remain less stringent than the respective standards for fraud, manipulation strike suits may become more prevalent. Michael Perino has suggested that securities litigation has actually increased since the passage of the PSLRA due to “portfolio diversification” by plaintiffs’ attorneys. Under his theory, it is rational for plaintiffs’ attorneys to file more suits, rather than less, in order to compensate for the increased risk that courts will dismiss more claims due to the PSLRA’s heightened pleading requirements. If his theory is correct, then it would also be rational for plaintiffs’ attorneys to file more manipulation claims. Given the lighter pleading requirements for market manipulation, more of these claims are likely to survive a motion to dismiss and eventually become profitable. Prudent portfolio diversification, therefore, should result in more market manipulation actions that are filed without regard for the merits of the claims—an outcome that would undermine the PSLRA’s goal of deterring strike suits.

Finally, lower standards for manipulation claims allow fraud claims to be brought that effectively bypass the heightened pleading standard of the PSLRA. Some courts have held that defendants that engage in market manipulation are under a duty to disclose that they are doing so. They may be liable for securities fraud, therefore, if they fail to disclose that fact. In essence, under less stringent pleading standards, plaintiffs can allege that defendants manipulated the market then use those allegations as the basis for a securities fraud claim. Under this interpretation, plaintiffs that sufficiently plead market manipulation will automatically satisfy the pleading requirements for fraud under the PSLRA, because nearly any public statement made by a defendant could be identified as misleading for

180. See Perino, supra note 81, at 936–37.
181. See id. at 937.
183. See, e.g., In re Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d at 381.
184. See, e.g., id. at 381–82.
failure to disclose a manipulative scheme. In sum, the PSLRA’s heightened pleading requirements for fraud can be circumvented in cases where manipulation is also alleged.

VI. PROPOSED CHANGES TO THE PLEADING REQUIREMENTS FOR MARKET MANIPULATION CLAIMS

This Part proposes how to resolve the problem with the pleading standards for manipulation claims. The recommendation is driven by a single principal: the problem with securities strike suits should be reflected in the pleading standards for manipulation claims. There are two ways to resolve this problem: a judicial solution and a legislative solution. For reasons discussed below, the legislative solution is preferable to the judicial solution. Finally, this Part addresses whether more demanding pleading requirements for manipulation claims would undermine the 1934 Act’s goal of deterring manipulation of securities markets. It concludes that it would not.

A. THE JUDICIAL SOLUTION

The judicial solution advocates an interpretation of the Federal Rules of Civil Procedure that courts can and should take to address the problems with the current market manipulation pleading standards. It argues that courts should adopt a flexible interpretation of Rule 9(b) in market manipulation claims that takes into consideration all three purposes of the particularity requirement—especially the goal of deterring strike suits, which commentators, courts, and Congress have all recognized as being particularly important in private securities suits. Additionally, this recommendation advances a straightforward and uniform system for addressing the sufficiency of market manipulation complaints.

185. See also Stephenson, 282 F. Supp. 2d at 1057 (“Plaintiffs’ proper allegations of market manipulation are, in fact, dispositive as to their claims of material omissions.”). It could be argued that using market manipulation as the basis for a fraud claim is erroneous because any loss that plaintiffs might suffer is attributable to the manipulation, not to a misstatement or omission. However, the IPO II court rejected this argument, reasoning that because the misstatements concealed the manipulation, plaintiffs’ loss was also attributable to those misstatements. See In re Initial Pub. Offering Sec. Litig., 297 F. Supp. 2d 668, 675–77 (S.D.N.Y. 2003). See also supra note 166.

186. A pleading standard that considers the danger of strike suits should also adequately protect the reputation of defendants.

187. See infra Part V.B.

188. See supra notes 3–5.
In market manipulation claims, courts should adopt a flexible interpretation of Rule 9(b) that considers the three purposes of the particularity requirement. Since courts have ignored the goals of protecting defendants’ reputations from harm and deterring strike suits in relaxing the pleading standards of Rule 9(b), the first step is to reincorporate these two goals when considering the ideal standard. Since Congress enacted the PSLRA in order to deter strike suits, its provisions are instructive on how best to achieve that goal, especially those that specifically address pleading requirements. The key feature that distinguishes the PSLRA from Rule 9(b) is the requirement that plaintiffs include a factual basis for their claims when making allegations on information and belief. It follows, therefore, that Congress believed that strike suits would be deterred by requiring plaintiffs to set forth a factual basis for their claims. Accordingly, courts that relax the pleading standard for manipulative conduct should require plaintiffs to provide a factual basis for their claims in order to advance Rule 9(b)’s goal of deterring strike suits. Requiring plaintiffs to set forth a factual basis for their allegations ensures that plaintiffs will investigate their claims before they file. Defendants, therefore, are better assured that their reputations will be safe from claims that lack any basis in fact. Furthermore, requiring plaintiffs to allege a basis in fact for their claims deters strike suits because courts will sanction them if they file groundless claims.

Requiring factual support for allegations, however, still does not address what the alleged facts must support. Given that “manipulation claims present circumstances in which the mechanism of the scheme is likely to be unknown to the plaintiffs,” plaintiffs should be permitted to allege less than the “who, what, where, when, and how” typically required to satisfy the manipulative conduct element under Rule 9(b). On the other hand, if plaintiffs simply allege facts, and nothing more, then defendants may not receive sufficient notice of the claim against them and courts may be unable to evaluate whether complaints state a claim entitling plaintiffs to relief. These competing interests make it clear that factual allegations must correlate to some general allegations regarding the wrongful conduct. Since the Second Circuit devised the nature, purpose, and effect test to place defendants on notice of the claims against them, it seems an appropriate standard for the manipulative conduct element. With respect to loss

189. See supra text accompanying notes 170–72.
191. See § 78u-4(c); FED. R. CIV. P. 11(b)-(c).
causation, allegations that defendants artificially inflated the price, and that plaintiffs sold at a deflated price, are sufficient to place the defendants on notice and allow the court to rule on the sufficiency of the complaint.

Combining a general pleading standard with a requirement for factual support will advance all three purposes of Rule 9(b). For manipulative conduct, the nature, purpose, and effect test will ensure that defendants have notice of their alleged wrongdoing. Similarly, general allegations of artificial inflation and deflation will demonstrate that plaintiffs are entitled to relief because they are alleging that defendants’ manipulation caused their loss and not something else, such as a market decline. The requirement for factual allegations supporting both manipulative conduct and loss causation will advance Congress’s goal of curtailing securities strike suits and protects the reputations of defendants from frivolous claims. Although no court currently requires factual support of loss causation in either fraud or manipulation claims, it should be required in both cases in order to support the goal of deterring securities strike suits.

Essentially, the judicial solution boils down to a three-prong analysis for assessing the sufficiency of a market manipulation claim. The first prong addresses whether the plaintiff has alleged a recoverable legal theory. Courts should therefore inquire into whether plaintiffs generally allege the nature, purpose, and effect of a scheme, and that they purchased at an artificially inflated price and sold at a deflated price. Second, courts should determine whether plaintiffs have attempted to allege facts in support of their general allegations of manipulative conduct and loss causation. The final step is evaluative; courts should appraise whether plaintiffs’ factual allegations actually support their general allegations.\(^{193}\)

While courts generally should not attempt to weigh evidence at the pleading stage,\(^ {194}\) some evaluation is necessary to promote the goal of deterring strike suits because, given the strong incentives to settle, most courts will never reach the merits of a claim.\(^ {195}\)

Additionally, the judicial solution has two other benefits. First, it prevents the circumvention of the heightened pleading requirements for fraud, since the pleading standards for manipulation will be level with those for fraud. Second, by breaking the analysis down into three steps, it

\(^{193}\) In an organized and well-pled complaint, the second and third prong should collapse into one.

\(^{194}\) See, e.g., Goldman v. Belden, 754 F.2d 1059, 1067 (2d Cir. 1985).

\(^{195}\) See, e.g., Alexander, supra note 2, at 524–26; Perino, supra note 81, at 921–22.
provides a straightforward model for assessing the sufficiency of manipulation actions.

To effectuate the proposed reinterpretation of Rule 9(b)’s particularity requirement, however, also requires a slightly different approach to Rule 12(b)(6). The present approach to Rule 12(b)(6) would negate the requirement of supporting factual allegations as courts dismiss a complaint only if “it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.” To effectuate the recommended pleading standards, courts should dismiss complaints that fail to plead factual support in addition to the general allegations. In fact, prior to the enactment of the PSLRA, the Second Circuit did dismiss securities claims that failed to allege sufficient facts to support a “strong inference” of scienter, although at the time, Rule 9(b) only required general averments of scienter. Interpreting Rule 12(b)(6) to permit dismissal of complaints that fail to satisfy the pleaded standard would effectively put manipulation claims on equal footing with fraud claims.

Finally, this proposal is not a recommendation for a new or judicially created heightened pleading requirement. In Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit, the Supreme Court noted that heightened pleading “is a result which must be obtained by the process of amending the Federal Rules, and not by judicial interpretation.” Leatherman, however, only prohibits courts from applying the heightened pleading standards of Rule 9(b) to claims that need only meet the notice pleading requirements of Rule 8(a). The proposed judicial solution is distinguishable from Leatherman, therefore, because Rule 9(b)’s heightened pleading requirements already apply to manipulation claims. Additionally, it is simply an interpretation of the word “particularity” as it is used in Rule 9(b), not a different requirement altogether. Like the current standard for pleading fraud and mistake under Rule 9(b)—the “who, what, when, where, and how” test—the judicial solution attempts to give meaning to the term “particularity.”

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200. See id. at 166–69.
B. THE LEGISLATIVE SOLUTION

A better solution to the problem is to amend the PSLRA to codify the changes recommended by the judicial solution. A legislative solution avoids bending the pleading rules in a way that might lead to an undesirable increase in appellate litigation in which plaintiffs and defendants seek application of flexible pleading standards in other contexts, and it would avoid circuit splits. Thus, formal codification would avoid that problem and, furthermore, would send a second message to courts that Congress recognizes the unique dangers inherent in the private securities litigation system.

First, Congress should add a new provision to the PSLRA to codify the pleading standards for manipulative conduct. A paragraph (b)(5) could be included to 17 U.S.C. § 78u-4, which would read:

(b)(5) In any private action arising under this chapter in which plaintiff alleges, on information and belief, that the defendant

(A) employed a scheme, device, or artifice to defraud; or

(B) engaged in an act, practice, or course of business that operates or would operate as a fraud or deceit upon any person,

the complaint shall state with particularity the nature, purpose, and effect of the alleged scheme and all facts on which that belief is formed.

The effect of this provision is to raise the pleading standards for manipulation claims to that of fraud claims. Since the paragraph is expressly limited to allegations made on information and belief, that is, those instances where the scheme is within the exclusive knowledge of the defendants, Rule 9(b) would apply exclusively to manipulation claims in which plaintiffs are able to allege the “who, what, when, where, and how.” Thus, this provision simply ensures that if plaintiffs seek a relaxed pleading requirement, they will specify the factual basis of their claim. As the judicial solution argued, requiring plaintiffs to specify the factual basis for their claims will help protect the reputations of defendants from baseless claims and deter plaintiffs from bringing strike suits.

Second, Congress should clarify the pleading standards for loss causation to ensure that it also applies to manipulation claims. 15 U.S.C. § 78u-4(b)(4) should be amended to read as follows:

201. It would be easy to limit a flexible interpretation of Rule 9(b) to securities claims given the well-documented ills associated with securities strike suits.
202. See supra note 90 and accompanying text.
In any private action arising under this chapter, the plaintiff shall have the burden of pleading and proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages. The court shall not presume the defendant’s act, omission, or conduct caused the plaintiff’s loss if only artificial inflation is alleged. If an allegation regarding the alleged loss is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

First, this amendment explicitly rejects the approach to loss causation taken by the Eighth and Ninth Circuits in favor of that taken by the Second, Third, and Eleventh Circuits. Second, it clarifies that plaintiffs must plead loss causation and, additionally, provide a factual basis for their allegations that defendants caused their loss. This will ensure that plaintiffs’ loss is attributable to the defendants’ wrongdoing, and not to something like a market decline. Furthermore, it will protect defendants’ reputations from harm and deter strike suits by requiring that a factual basis exists for plaintiffs’ claims.

Finally, amending 15 U.S.C. § 78u-4(b)(3)(A) is necessary to ensure that manipulation claims that fail to meet the proposed pleading requirements are automatically dismissed. It would therefore read:

In any private action arising under this Act, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1), (2), (4), or (5) are not met.

The effect of this amendment is simply to extend 15 U.S.C. § 78u-4(b)(3)(A) to the newly created 15 U.S.C. § 78u-4(b)(5) and to the amended 15 U.S.C. § 78u-4(b)(4) so that courts dismiss claims that fail to meet the pleading standards.

In sum, this would essentially duplicate the judicial solution, but make it expressly authorized in the PSLRA. The result is that the pleading requirements for market manipulation and fraud will be nearly identical. Thus, plaintiffs will no longer be able to circumvent the provisions and policy of the PSLRA by alleging manipulation rather than fraud.

203. Italics indicate the proposed changes to the current provision.
204. Italics indicate the proposed changes to the current provision.
C. WILL THE PROPOSED SOLUTIONS UNDERMINE THE GOAL OF DETERRING MANIPULATION OF SECURITIES MARKETS?

Imposing a requirement for factual allegations in manipulation claims will not undermine the 1934 Act’s objective of deterring manipulation of the securities markets. Congress’s efforts “to reform the private securities litigation system was both broad-based and bipartisan,” because it enacted the PSLRA in the belief that it was balancing the competing policies of deterring fraud and deterring frivolous litigation. It would likely view the pleading standards recommended by the judicial and legislative solutions for manipulative conduct as similarly balancing those competing interests, since both solutions advance a pleading standard for manipulative conduct that is similar to the PSLRA’s requirements for misstatements and scienter. Even the recommendation for factual allegations in support of loss causation does not extend the two solutions beyond the underlying principles of the PSLRA. Rather, requiring plaintiffs to allege facts in support of their claims helps advance the PSLRA’s overall goal of deterring strike suits.

Furthermore, recent increases in enforcement of the securities laws, at both the state and federal level, ensure that the deterrence objective is not undermined. After the parade of scandals following the Enron fiasco, many state regulators demonstrated their willingness to pursue state enforcement actions against securities law violators. Additionally, in 2002 and 2003 the SEC initiated 1278 enforcement actions, which represented a twenty-nine percent increase in enforcement activity compared to 2000 and 2001. Federal enforcement of securities laws has become so much more effective that even New York Attorney General Elliot Spitzer has indicated that he will yield to federal regulators on future investigations.

Additionally, the criminal penalties for violating the federal securities laws have been increased. Section 32(a) of the 1934 Act and 18 U.S.C. §

205. Phillips & Miller, supra note 2, at 1026.
enacted under the Sarbanes-Oxley Act of 2002, impose criminal penalties on people that manipulate securities markets. The requirements for a criminal prosecution under section 32(a) are essentially the same as those required to impose civil liability under Rule 10b-5 and Section 10(b). A conviction under section 32(a) is punishable by a fine up to $5,000,000 ($25,000,000 for corporations) or twenty years in prison or both. Moreover, 18 U.S.C. § 1348, titled “Securities Fraud,” appears to criminalize a broader range of conduct than section 32(a). It prohibits “knowing[] . . . attempts to execute, a scheme or artifice to defraud any person in connection with any security” of a publicly traded company. Thus, it appears to criminalize the mere attempt to employ a “scheme or artifice to defraud” in connection with the security of a publicly traded company without the need to show that anyone actually purchased or sold the security, relied on the scheme, or suffered harm. Conviction under this section can result in a fine, imprisonment of up to twenty-five years, or both. In sum, the combination of increased enforcement and heightened criminal penalties will continue to protect the 1934 Act’s goal of deterring market manipulation.

VII. CONCLUSION

Congress enacted the PSLRA in order to address the problem of securities strike suits. Yet courts have failed to recognize this concern in fashioning the pleading standards under Rule 9(b) for market manipulation claims. Furthermore, the circuit courts have produced inconsistent standards for alleging loss causation in securities claims, none of which take into account the danger of strike suits in securities claims. This Note proposes two solutions to incorporate Congress’s concern for securities strike suits into the pleading requirements for market manipulation claims.

215. See Joseph Conahan, Janine Loaisiga Ivanova, Paul Nolette & Aram Young, Securities Fraud, 40 AM. CRIM. L. REV. 1041, 1050–51 (2003) (noting that a distinction has yet to be drawn between scienter in the civil context and willfulness in the criminal context).
217. See § 1348(1).
218. 18 U.S.C. § 1346 defines “scheme or artifice to defraud” as a “scheme or artifice to deprive another of the intangible right of honest services.” 18 U.S.C.A. § 1346 (West 2004). However, there appears to be a controversy over what exactly that definition means. See United States v. Rybicki, 354 F.3d 124, 162–63 (2d Cir. 2003) (en banc) (Jacobs, J., dissenting).
219. § 1348.
The first solution is judicial, arguing that courts should reevaluate the pleading requirements for market manipulation in light of the three purposes of Rule 9(b)’s particularity requirement and Congress’s concerns as expressed through the PSLRA. The second solution is legislative and argues that Congress should amend the PSLRA in order to achieve parity between fraud and manipulation claims and to clarify and strengthen the pleading requirements for loss causation. Given the danger of strike suits in the private securities litigation system, the judicial and legislative solutions will better assure that strike suits are deterred.