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Beyond the Target Market: Product Advertising and Rule 10B-5's in Connection with Requirement

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BEYOND THE TARGET MARKET: PRODUCT ADVERTISING AND RULE 10B-5'S "IN CONNECTION WITH" REQUIREMENT

THOMAS J. MOLONY*

ABSTRACT

An investor purchases Apple common stock in reliance on representations in advertisements that the new iPad is capable of connecting to "ultrafast" 4G wireless networks. It turns out that the iPad is not compatible with the fastest wireless network in Australia or the 4G networks in Sweden and Germany. If the investor suffered a loss as a result, can the investor recover from Apple for securities fraud under Rule 10b-5 of the Securities Exchange Act of 1934?

A number of possible impediments to recovery exist. One is Rule 10b-5's limited scope. The Rule applies only to a fraud that is "in connection with" a securities transaction, and whether a false or misleading statement primarily directed to consumers has the requisite connection is an open question.

This Article evaluates Rule 10b-5's "in connection with" requirement as it relates to product advertisements and concludes that false or misleading statements in advertisements are actionable under the Rule. The Article also suggests that, to determine whether a particular advertisement meets the "in connection with" requirement, courts should look to factors considered in determining whether an advertisement is an "offer" under the Securities Act of 1933.

INTRODUCTION	102
I. RULE 10B-5—AN OVERVIEW	105
II. RULE 10B-5'S "IN CONNECTION WITH" REQUIREMENT	108
<i>A. The Supreme Court's Limited Guidance</i>	108
<i>B. Varying Approaches of the Courts of Appeals</i>	112
<i>C. Publicly Disseminated Information Principles</i>	115
III. HISTORICAL CONSIDERATION OF ADVERTISEMENTS AND THE "IN CONNECTION WITH" REQUIREMENT	119
<i>A. Advertising Cases</i>	119
<i>B. Criticism of Carter-Wallace</i>	122
IV. ADVERTISEMENTS MAY MEET THE "IN CONNECTION WITH" REQUIREMENT.....	123
<i>A. Publicly Disseminated Information Principles Allow for Advertisements to Meet the "In Connection With" Requirement</i>	123
<i>B. Empirical Studies Indicate that Product</i>	

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	<i>Advertising Affects Investor Decisions and that Managers Use Advertising for that Purpose</i>	124
C.	<i>The Approach to “Offers” Under the Securities Act of 1933 Recognizes the Possible Effect of Advertisements on Investors</i>	126
	1. The “Gun-Jumping Rules”	126
	2. 2005 Securities Offering Reform	129
V.	DETERMINING WHEN AN ADVERTISEMENT MEETS THE “IN CONNECTION WITH” REQUIREMENT	131
A.	<i>Public Companies and the Causation-Based Approach</i>	131
B.	<i>Factors from the Approach to “Offers” Under the Securities Act of 1933</i>	133
	CONCLUSION	134

INTRODUCTION

Introducing the new iPad. With the stunning Retina display. 5 MP iSight camera. And ultrafast 4G LTE.

It’s brilliant. In every sense of the word. Pick up the new iPad and suddenly, it’s clear. You’re actually touching your photos, reading a book, playing the piano. Nothing comes between you and what you love. To make that hands-on experience even better, we made the fundamental elements of iPad better—the display, the camera, the wireless connection. All of which makes the new, third-generation iPad capable of so much more than you ever imagined.¹

Apple excitedly released its new iPad across the globe in March 2012,² but for those in Australia, Sweden, and Germany, Apple’s suggestion that the device was “capable of so much more than [they] ever imagined” did not necessarily ring true—at least not as to the 4G LTE wireless connection. The new iPad, it turned out, was incompatible with the fastest wireless network in Australia and the 4G networks in Sweden and Germany.³ Purchasers of new iPads in those countries had a right to be disappointed.

In Australia, Apple had marketed one model of the new iPad as “iPad with WiFi + 4G,” using that designation on its Australian website and online store, on signs in Apple retail stores, and in marketing materials provided to and used by other

¹ Shirley Brady, *Is Apple’s New iPad Revolutionary Enough to Drive Sales?*, BRANDCHANNEL (Mar. 7, 2012 4:31 PM), <http://www.brandchannel.com/home/post/Apple-iPad-3-Reveal-030712.aspx>.

² See *id.* (reproducing “Apple’s iPad 3 pitch”).

³ Robb M. Stewart, *New iPad Sparks Debate Over 4G Overseas*, WALL ST. J. (Mar. 29, 2012 2:33 PM), <http://online.wsj.com/article/SB10001424052702303816504577308282123733976.html>.

retailers.⁴ The fact that the iPad was incompatible with the Telstra LTE network, the only commercially available LTE network in Australia at the time of the new iPad's release, caught the attention of the Australian Competition & Consumer Commission (ACCC). The ACCC filed a lawsuit against Apple in the Federal Court of Australia, claiming that using the "iPad with WiFi + 4G" designation was misleading to consumers and violated the Australian Consumer Law.⁵ In response to the lawsuit, Apple agreed to modify its website and promotional materials to make clear that the new iPad was not compatible with the Telstra network and offered refunds to those who purchased new iPads before the ACCC filed its suit.⁶

As a result of Apple's compliance with the ACCC's demands, consumers in Australia were made whole. But what about an investor who purchased Apple common stock in reliance on the statements on Apple's website and other promotional materials about the iPad's ability to connect with 4G networks? If Apple's statements were in fact misleading⁷ and the investor suffered a loss as a result, could the investor recover from Apple for violating the antifraud prohibition of Rule 10b-5⁸ under the Securities Exchange Act of 1934 (Exchange Act)?⁹ The answer depends in part on whether Apple's statements were made "in connection with" the investor's purchase of Apple common stock.¹⁰

⁴ *Australian Competition & Consumer Comm'n v. Apple Pty Ltd.* [2012] FCA 646, ¶ 12 (Austl.), available at <http://www.austlii.edu.au/au/cases/cth/FCA/2012/646.html>.

⁵ See *ACCC to Seek Orders Against Apple for Alleged Misleading iPad "4G" Claims*, AUSTRALIAN COMPETITION & CONSUMER COMM'N (Mar. 27, 2012), <http://www.accc.gov.au/content/index.phtml/itemId/1042020> ("The Australian Competition and Consumer Commission will be making an application to the Federal Court in Melbourne . . . for orders against Apple Pty Limited and Apple Inc (Apple) for alleged contraventions of the Australian Consumer Law (ACL).").

⁶ *Apple Pty Ltd Provides Undertaking in Response to ACCC "iPad with WiFi + 4G" Urgent Application*, AUSTRALIAN COMPETITION & CONSUMER COMM'N (Mar. 28, 2012), <http://www.accc.gov.au/content/index.phtml/itemId/1042357>. In June 2012, the Australian Federal Court fined Apple AUD \$2.25 million for violating the consumer law. *Apple*, [2012] FCA 646 at ¶ 51.

⁷ In the lawsuit brought by the ACCC, Apple admitted that the designation "iPad with WiFi + 4G" was misleading to consumers. *Apple*, [2012] FCA 646 at ¶ 11. Such an admission does not mean, however, that the designation would have been misleading to investors. This is particularly true in light of the fact that a footnote on Apple's website stated at the time of the ACCC lawsuit that "4G LTE is supported only on AT&T and Verizon networks in the U.S. and on Bell, Rogers, and Telus networks in Canada." See Stewart, *supra* note 3.

⁸ 17 C.F.R. § 240.10b-5 (2012).

⁹ 15 U.S.C. §§ 78a–78nn (2006).

¹⁰ See 17 C.F.R. § 240.10b-5 (2012) (applying only when a fraud is "in connection with the purchase or sale of any security"). That a false or misleading statement was "in connection with" a securities transaction is only one of several elements that a plaintiff must establish to recover under Rule 10b-5. See *infra* notes 24–26 and accompanying text (describing the elements of a private cause of action under Rule 10b-5).

Rule 10b-5's scope is broad,¹¹ but not unlimited. It extends only to fraud that is "in connection with the purchase or sale of [a] security."¹² Courts have struggled to define the meaning of this limit, however, and whether a false or misleading statement in a product advertisement—which typically is directed to customers and not investors—is within the limit is an open question.

This Article contends that false and misleading statements in product advertisements may meet Rule 10b-5's "in connection with" requirement. Finding support in recent empirical studies regarding the effect of advertising on the market prices of securities and in the treatment of advertisements under provisions of the Securities Act of 1933 (Securities Act) governing securities offerings, the Article concludes that product advertisements can satisfy the "in connection with" tests applicable to publicly disseminated statements.

Part I of this Article offers an overview of Rule 10b-5 and the elements for civil enforcement actions, criminal prosecutions, and private causes of action under the Rule. Part II follows with a detailed discussion of the "in connection with" requirement. It explains the limited guidance provided by the Supreme Court, the various general approaches taken by the United States Courts of Appeals, and the rules applied by certain courts of appeals to cases involving publicly disseminated statements. In Part III, the Article discusses the handful of cases that have considered whether statements in product advertisements can satisfy the "in connection with" requirement. Part III also explains the criticisms leveled against the only federal appellate decision with respect to product advertisements. Responding to these criticisms, Part IV explains why false or misleading statements in product advertisements may satisfy Rule 10b-5's transactional nexus requirement. It spells out how product advertisements fit within the principles courts have applied to publicly disseminated information, describes the conclusions reached in recent empirical studies as to the effect of advertising on securities prices, and details how product advertisements are treated for purposes of the Securities Act. Part V suggests that, if the "in connection with" requirement merely demands a causal connection, product advertisements of public companies likely will satisfy the requirement in most cases. Drawing on principles and rules used to determine when an advertisement represents an "offer" for purposes of the Securities Act, Part V also recommends factors that courts should consider in determining whether the "in connection with" requirement is met with respect to a particular advertisement. The Article concludes that Rule 10b-5's "in connection with" requirement is not a serious impediment to a securities fraud claim arising out of false or misleading statements in product advertisements and that companies that fail to bear this in mind when crafting marketing materials do so at their own peril.

¹¹ See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 12.1[3][B][2], at 437 (6th ed. 2009) ("Rule 10b-5 is the broadest of the section 10(b) rules. . . . Because of its broad language, Rule 10b-5 covers a wide variety of conduct . . .").

¹² 17 C.F.R. § 240.10b-5 (2012); see *Marine Bank v. Baker*, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.").

I. RULE 10B-5—AN OVERVIEW

Rule 10b-5, which the Securities and Exchange Commission (SEC) adopted in 1942 pursuant to its authority under Exchange Act § 10(b),¹³ is perhaps the most far-reaching antifraud provision of the federal securities laws.¹⁴ The Rule proscribes at least three different categories of fraud:¹⁵ (i) misstatements,¹⁶ (ii) misleading statements,¹⁷ and (iii) pure omissions (*i.e.*, silence when there is a duty to disclose certain information).¹⁸ False or misleading statements and omissions are prohibited, however, only when they are material—that is, when there is a “substantial likelihood that the [statement or omission] would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”¹⁹ Moreover, to run afoul of Rule 10b-5, a person must act with scienter, which the Supreme Court has defined as “a mental state embracing intent to deceive, manipulate, or defraud”²⁰ and which lower courts have expanded to include reckless behavior.²¹

¹³ 15 U.S.C. § 78j(b) (2006); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir. 1952).

¹⁴ *See HAZEN*, *supra* note 11, § 12.3[2], at 442 (noting that “[i]n Rule 10b-5 [the SEC] fashioned its most encompassing antifraud prohibition [and] . . . , without even realizing its eventual reach, created a powerful antifraud weapon”).

¹⁵ *See* STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 281 (3d ed. 2012) (identifying “omissions in breach of fiduciary duty,” “half-truths,” and “affirmative misstatements” as three categories of Rule 10b-5 fraud). The Rule may extend beyond these three categories because it more generally prohibits “any device, scheme, or artifice to defraud” and “any act, practice, or course of business which operates or would operate as a fraud or deceit.” 17 C.F.R. § 240.10b-5(a), (c) (2012).

¹⁶ *See* 17 C.F.R. § 240.10b-5(b) (2012) (“It shall be unlawful for any person . . . [t]o make any untrue statement of a material fact.”).

¹⁷ *See id.* (“It shall be unlawful for any person . . . 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 . . .”).

¹⁸ *See* 17 C.F.R. § 240.10b-5(a), (c) (2012); *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (indicating that liability for a failure to disclose material information only arises if there is a duty to disclose); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-53 (1972) (noting that Rule 10b-5’s prohibition against fraud by pure omission is found in the first and third subparagraphs of the Rule).

¹⁹ *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988).

²⁰ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The Court stated expressly that it was not ruling on whether recklessness may constitute scienter. *See id.* (“We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.”). In *Aaron v. SEC*, the Supreme Court determined that scienter also is required for SEC enforcement actions. *Aaron v. Sec. & Exch. Comm’n*, 446 U.S. 680, 691 (1980); *see HAZEN*, *supra* note 11, § 12.8[1], at 457 (“The Supreme Court . . . held in *Aaron v. SEC* that the scienter standard applies under Rule 10b-5 regardless of whether the action is one for damages or an enforcement action brought by the Commission.”).

²¹ *See, e.g., Sec. & Exch. Comm’n v. Todd*, 642 F.3d 1207, 1215 (9th Cir. 2011) (“Reckless conduct may also constitute scienter.”); *Makor Issues & Rights, Ltd. v. Tellabs*

Rule 10b-5 is subject both to civil enforcement by the SEC and criminal enforcement by the United States Department of Justice.²² To be successful in a civil enforcement action or criminal prosecution, the SEC or the Department of Justice must prove that the defendant made a material misstatement or omission and acted with scienter and that the misstatement or omission was made “in connection with” a securities transaction.²³

Rule 10b-5 also may be enforced by private plaintiffs.²⁴ Standing for a private cause of action, however, is limited to purchasers and sellers of securities and does not extend to those who fail to purchase or sell securities because of fraudulent misstatements or omissions.²⁵ To prevail in a private cause of action, in addition to elements that the SEC and the Department of Justice must prove (material misstatement or omission, scienter, and connection to a securities transaction), a plaintiff must establish that he or she reasonably relied on the misstatement or omission and that the misstatement or omission caused a loss to the plaintiff.²⁶

Although reliance generally is required for a private cause of action under Rule 10b-5, the Supreme Court has reduced the burden on plaintiffs to prove reliance in

Inc., 513 F.3d 702, 704 (7th Cir. 2008) (“[L]iability requires proof of the defendant’s ‘scienter,’ which is to say proof that he either knew a statement was false or was reckless in disregarding the substantial risk that it was false.”); *ATSI Commc’ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 n.3 (2d Cir. 2007) (“In a Rule 10b-5 action, scienter requires a showing of ‘intent to deceive, manipulate, or defraud,’ or reckless conduct. (internal citations omitted); *Robert N. Clemens Trusts v. Morgan Stanley DW, Inc.*, 485 F.3d 840, 847 (6th Cir. 2007) (“[W]e have ‘long premised liability on at least reckless behavior.’”); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (“Our circuit, . . . along with ten other circuits, has held that recklessness may satisfy the element of scienter in a civil action for damages under § 10(b) and Rule 10b-5.”).

²² See 15 U.S.C. § 78u (2006) (authorizing SEC actions to enforce rules under the Exchange Act); 15 U.S.C. § 78ff (2006) (providing for fines and imprisonment).

²³ See *Sec. & Exch. Comm’n v. Pirate Investor LLC*, 580 F.3d 233, 239 (4th Cir. 2009) (listing the elements of a civil enforcement action); *United States v. Teyibo*, 877 F. Supp. 846, 861 (S.D.N.Y. 1995) (listing the requirements for a criminal prosecution). In a criminal prosecution, a higher standard for scienter applies, requiring the government to prove that the defendant acted willfully; see 15 U.S.C. § 78ff(a) (2006) (requiring a willful violation of the Exchange Act for imprisonment or criminal penalty).

²⁴ Although the text of the Rule does not specify a private cause of action, courts have found that one is implied. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); see also *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (“It is now established that a private right of action is implied under § 10(b).”).

²⁵ See *Blue Chip Stamps*, 421 U.S. at 730-31 (noting that, in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), the Second Circuit determined that plaintiffs in a private cause of action under Rule 10b-5 were “limited to actual purchasers and sellers of securities” and holding that *Birnbaum* was decided correctly).

²⁶ See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008) (listing the elements of a private cause of action); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 338 (2005) (“A private plaintiff who claims securities fraud must prove that the defendant’s fraud caused an economic loss.”); *Semerenko v. Cendant Corp.*, 223 F.3d 165, 174 (3d Cir. 2000) (listing the elements of a private cause of action); *United Int’l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1220 (10th Cir. 2000) (same).

two significant respects. First, if a fraud is accomplished through a pure omission, a plaintiff need not prove reliance at all.²⁷ Second, for securities traded in an efficient market, a plaintiff may qualify for a rebuttable presumption of reliance.²⁸

The Supreme Court in *Basic v. Levinson* approved the use of a presumption of reliance based on the “fraud-on-the market” theory,²⁹ which posits that materially false or misleading statements made to the public affect the market price of a security and that a person purchasing at the market price may be defrauded even if the person does not know of the statements.³⁰ The United States Court of Appeals for the Seventh Circuit has explained:

When someone makes a false (or true) statement that adds to the supply of available information, that news passes to each investor *through the price of the stock*. And since all stock trades at the same price at any one time, every investor effectively possesses the same supply of information. The price both transmits the information and causes the loss. This approach, dubbed the fraud-on-the-market doctrine, supplants “reliance” as an independent element by establishing a more direct method of causation.³¹

Accordingly, to qualify for the presumption, courts generally require a plaintiff to prove that the applicable securities were traded in an efficient market and that the defendant publicly made misrepresentations.³²

²⁷ See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153 (1972) (“Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material . . .”).

²⁸ See *Basic v. Levinson*, 485 U.S. 224, 247 (1988) (“Because most publicly available information is reflected in market price, an investor’s reliance on any public misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.”).

²⁹ See *id.* at 250 (“It is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory.”).

³⁰ See *id.* at 241-42 (explaining the “fraud-on-the-market” theory). The United States Court of Appeals for the First Circuit has explained the theory as follows:

The fraud-on-the-market presumption of reliance and its relationship to market efficiency can thus be reduced to the following syllogism: (a) an investor buys or sells stock in reliance on the integrity of the market price; (b) publicly available information, including material misrepresentations, is reflected in the market price; and therefore, (c) the investor buys or sells stock in reliance on material misrepresentations. This syllogism breaks down, of course, when a market lacks efficiency, and the market does not necessarily reflect the alleged material misrepresentation.

In re Polymedica Corp. Sec. Litig., 432 F.3d 1, 8 (1st Cir. 2005).

³¹ *Schleicher v. Wendt*, 618 F.3d 679, 682 (7th Cir. 2010).

³² See, e.g., *Basic*, 485 U.S. at 248 n.27 (noting the elements required by the Sixth Circuit for the presumption); *Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, 660 F.3d 1170, 1172 (9th Cir. 2011) (describing the requirements for the presumption); *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631 (3d Cir. 2011) (same); *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 481 (2d Cir. 2008) (same); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 264 (5th Cir. 2007) (same).

II. RULE 10B-5'S "IN CONNECTION WITH" REQUIREMENT

A. *The Supreme Court's Limited Guidance*

In 1989, Edward Fletcher identified six different categories of cases in which Rule 10b-5's "in connection with" requirement is at issue.³³ The Supreme Court, however, has addressed the requirement in only three cases, all of which were in a single category. In all three cases, the relevant fraud involved the misappropriation of assets, and in all three, the Court found that the fraud was "in connection with" a securities transaction for purposes of Rule 10b-5.³⁴

The Supreme Court first addressed Rule 10b-5's "in connection with" requirement—or the "transactional nexus" requirement, as it is sometimes called³⁵—in 1971 in *Superintendent of Ins. v. Bankers Life & Casualty Co.*, which involved a complex scheme under which the purchaser of a corporation's stock misappropriated corporate assets to pay the purchase price of the stock.³⁶ Twenty-five years later in *United States v. O'Hagan*, the Court considered whether trading in securities of a company based on information misappropriated from someone other than the company represents fraud "in connection with" a securities transaction in violation of the prohibition against insider trading under Rule 10b-5.³⁷ Most recently, in *SEC v. Zandford*, the Court addressed whether a broker's misappropriation of proceeds of sales of his clients' securities met the "in connection with" requirement.³⁸

In *Bankers Life*, the Court famously declared that a fraud must "touch" a securities transaction to have the necessary transactional nexus.³⁹ Similarly, in *O'Hagan* and *Zandford*, the Court emphasized that, to meet the "in connection with" requirement, a fraud must "coincide" with a securities transaction.⁴⁰ These characterizations, while often repeated, provide little practical guidance regarding

³³ See C. Edward Fletcher, III, *The "In Connection With" Requirement of Rule 10b-5*, 16 PEPP. L. REV. 913, 929-59 (1989) (identifying and discussing six common fact scenarios appearing in transactional nexus cases).

³⁴ Sec. & Exch. Comm'n v. *Zandford*, 535 U.S. 813, 825 (2002); *United States v. O'Hagan*, 521 U.S. 642, 655-56 (1997); *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 9 (1971).

³⁵ See, e.g., *Sec. & Exch. Comm'n v. Wolfson*, 539 F.3d 1249, 1255 (10th Cir. 2008) (describing claim that a fraud "lacked the requisite nexus to any securities transactions" as an argument that the "in connection with" requirement was not met); *Ind. Elec. Workers Pension Trust Fund v. Millard*, No. 07 Civ. 172(JGK), 2007 WL 2141697, at *6 (S.D.N.Y. July 25, 2007) ("[F]raud is 'in connection with' a purchase or sale when there is a 'transactional nexus' between the fraud and the transaction.").

³⁶ *Bankers Life*, 404 U.S. at 10.

³⁷ *O'Hagan*, 521 U.S. at 652-53.

³⁸ *Zandford*, 535 U.S. at 815.

³⁹ See *Bankers Life*, 404 U.S. at 12-13 ("The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities to an investor.").

⁴⁰ *Zandford*, 535 U.S. at 822 ("It is enough that the scheme to defraud and the sale of securities coincide."); *O'Hagan*, 521 U.S. at 656 ("The securities transaction and the breach of duty thus coincide.").

how far Rule 10b-5 extends. As some have noted, to say that a fraud must “touch” or “coincide” with a securities transaction does little more than restate the requirement under Rule 10b-5 that a fraud be “in connection with” a securities transaction.⁴¹

O’Hagan and *Zandford*, though, did more than just rephrase the “in connection with” requirement. In each case, the Court determined that the misappropriation at issue met the “in connection with” requirement because a securities transaction was necessary to complete the fraud.⁴² It is unclear, however, whether the Court intended this necessity test to apply outside the misappropriation context.

Regardless of what the Court in *O’Hagan* and *Zandford* may have intended, lower courts have applied the necessity test to cases not involving misappropriation, and they have done so with varying degrees of success. Two examples are the decision of the United States Court of Appeals for the Third Circuit in *Rowinski v. Salomon Smith Barney Inc.*⁴³ and the decision of the United States Court of Appeals for the Fourth Circuit in *SEC v. Pirate Investor LLC*.⁴⁴ A comparison of the two cases illustrates the limitations of the necessity test and suggests that the test does not—or should not—apply broadly to the “in connection with” requirement.

In *Rowinski*, retail brokerage customers of Salomon Smith Barney (SSB) sued SSB, alleging that, to “reap hundreds of millions of dollars in investment banking fees,” SSB had produced investment research reports that reflected overly favorable views of its investment banking clients.⁴⁵ The customers did not claim, however, that SSB had violated Rule 10b-5. Instead, they brought state law claims for breach

⁴¹ See *Roland v. Green*, 675 F.3d 503, 512 (5th Cir. 2012) (“But the test [the Supreme Court] has offered—whether or not ‘the fraud alleged “coincide[s]” with a securities transaction—is not particularly descriptive.” (internal citations omitted) (emphasis in original)); *Sec. & Exch. Comm’n v. Pirate Investor LLC*, 580 F.3d 233, 244 (4th Cir. 2009) (“[T]o say that a fraud is ‘in connection with’ a securities transaction whenever it ‘coincides’ with that transaction hardly clarifies the matter.”); *Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942 (2d Cir. 1984) (“We are inclined to agree . . . that ‘there is no reason to believe that [Justice Douglas’s] use of “touching” [in *Bankers Life*] was anything more than his variation of “in connection with” as a matter of literary style.”); *Fletcher*, *supra* note 33, at 962 (emphasizing that the concept of “touching” was a product of Justice’s Douglas’s literary style and that he merely was stating in a different way that the fraud must be “in connection with” a securities transaction).

⁴² See *Zandford*, 535 U.S. at 820 (“The securities sales and respondent’s fraudulent practices were not independent events.”); *id.* at 825 (“[T]he fraud was not complete before the sale of securities occurred.”); *O’Hagan*, 521 U.S. at 656 (noting that the “in connection with” requirement “is satisfied because the fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities.”).

⁴³ See *Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 302 (3d Cir. 2005) (citing *Zandford*, 535 U.S. at 825, and considering whether the fraud “necessarily ‘coincides’ with the purchase or sale of securities”).

⁴⁴ See *Pirate Investor*, 580 F.3d at 244 (citing *Zandford*, 535 U.S. at 820-21, and including as a factor in a multi-factor test “whether a securities sale was necessary to the completion of the fraudulent scheme”).

⁴⁵ *Rowinski*, 398 F.3d at 296-97.

of contract, unjust enrichment, and violations of consumer protection laws,⁴⁶ and the question the Third Circuit faced was whether the state law claims were permitted under the Securities Litigation Uniform Standards Act,⁴⁷ a 1998 law that precludes certain state law class actions with respect to fraud “*in connection with* the purchase or sale of” securities.⁴⁸ To answer this question, the Third Circuit applied precedent with respect to the “in connection with” requirement under Rule 10b-5.⁴⁹ Based on that precedent, the Third Circuit found that securities transactions coincided with the fraud as contemplated by *Zandford* because the transactions were necessary to the success of the alleged fraud.⁵⁰ The court reasoned that, without the transactions, the share prices of SSB’s investment banking clients would not have increased and, without increases in the share prices, the clients would not have given SSB the investment banking business SSB wanted.⁵¹

In *Pirate Investor*, the Fourth Circuit considered whether an e-mail stock tip containing misrepresentations violated Rule 10b-5.⁵² In May 2002, the editor-in-chief of Pirate Investor, LLC, a publisher of investment newsletters, sent multiple

⁴⁶ *Id.*

⁴⁷ *Id.* at 296.

⁴⁸ 15 U.S.C. §§ 77p(b), 78bb(f)(1) (2006). Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA) to curb state law class action lawsuits with respect to nationally-traded securities that began to arise after Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA). 15 U.S.C. §§ 77z-1, 78u-4 (2006); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 82 (2006). In the PSLRA, Congress adopted a number of measures designed to curtail abuses in federal antifraud class action lawsuits involving nationally traded securities. *Id.* at 81. Among other things, PSLRA established stringent pleading requirements, limited damages and attorneys’ fees, allowed discovery to be stayed until any motion to dismiss was resolved, and penalized those bringing frivolous lawsuits. *Id.* at 81-82. After PSLRA was enacted, plaintiffs started bringing securities class actions under state law to avoid PSLRA’s restrictions. *Id.* at 82. SLUSA was designed to stop the proliferation of these lawsuits by providing for federal preemption of state law class actions brought on behalf of over fifty people in which a plaintiff alleges “a misrepresentation or omission of a material fact *in connection with* the purchase or sale of a covered security” or “that the defendant used or employed any manipulative or deceptive device or contrivance *in connection with* the purchase or sale of a covered security.” 15 U.S.C. § 78bb(f)(1) (2006) (emphasis added).

⁴⁹ *Rowinski*, 398 F.3d at 299. The Supreme Court later indicated the meaning of the phrase “in connection with” is the same under SLUSA as it is under Rule 10b-5. *See Dabit*, 547 U.S. at 85 (considering the meaning of the phrase “in connection with” in SLUSA and indicating that “when judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well”). Accordingly, other courts have concluded that the phrase “‘in connection with the purchase or sale’ of a security under SLUSA covers the same range of activities that the SEC could prosecute as violations of § 10(b) and Rule 10b-5.” *Instituto De Prevision Militar v. Merrill Lynch*, 546 F.3d 1340, 1348 (11th Cir. 2008); *Siepel v. Bank of Am., N.A.*, 526 F.3d 1122, 1127 (8th Cir. 2008).

⁵⁰ *Rowinski*, 398 F.3d at 302.

⁵¹ *Id.*

⁵² *Sec. & Exch. Comm’n v. Pirate Investor LLC*, 580 F.3d 233, 236 (4th Cir. 2009).

waves of e-mails containing a stock tip to over 800,000 individuals.⁵³ The e-mails suggested that, based on information purportedly obtained from a senior executive of a mystery company, the editor knew that the mystery company was going to announce a major transaction on May 22 and that investors could profit from buying the mystery company's stock prior to that time.⁵⁴ The e-mails further indicated that, for \$1,000, an e-mail recipient could receive a special report divulging the name of the mystery company.⁵⁵ Pirate received over \$600,000 from sales of the special report to over 1,200 investors.⁵⁶ Unfortunately for those who purchased the report and the stock of the mystery company, May 22 came and went without any announcement, and it turned out that a mystery company senior executive had not told Pirate's editor that the transaction was to be announced on that date.⁵⁷

According to the Fourth Circuit, the facts in *Pirate Investor* indicated that a securities transaction was necessary to complete the fraud. The court explained that Pirate sent out its e-mails in multiple waves and that the e-mails in later waves touted stock purchases by investors who had received earlier e-mails and highlighted the fact that the mystery company's stock price had risen, which the district court found resulted from the earlier purchases.⁵⁸ The court concluded, then, that "[t]he fraud was not complete when investors paid \$1,000 to learn the identity of the company in question; [the defendants] also needed those investors to purchase the stock thereby increasing the stock price so as to boost the credibility of the solicitation e-mail to obtain more \$1,000 payments."⁵⁹

Unlike the straightforward and sensible application of the necessity test in *Rowinski*, the Fourth Circuit in *Pirate Investor* strained to conclude that a securities transaction was necessary to complete the fraud involved in the case. While it may be true that Pirate *benefited* from actual purchases of the mystery company's stock, by no means were the purchases *necessary* to complete the fraud. The fraud with respect to each investor was complete when the investor paid for the special report that revealed the identity of the mystery company. Unlike the misappropriation in *Zandford*, no intervening securities transaction was necessary to complete the fraud. Purchases by earlier investors may have aided Pirate in defrauding later investors, but purchases of the special reports by later investors could have been completed without anyone's having made a purchase.

The Fourth Circuit's tortured application of the necessity test in *SEC v. Pirate Investor* suggests that the test does not, or at least should not, apply broadly to the "in connection with" requirement. Even though the test can be applied reasonably—as it was in *Rowinski*—courts should not need to strain to find the appropriate connection in a case such as *Pirate Investor* where application of Rule 10b-5 so

⁵³ *Id.* at 237-39.

⁵⁴ *Id.* at 238.

⁵⁵ *Id.*

⁵⁶ *Id.* at 239. The opinion does not explain why Pirate received only a portion of the total net proceeds from the sales. See *id.* (noting that Pirate received only \$626,500 of the total net proceeds of \$1,005,000).

⁵⁷ *Id.* at 240.

⁵⁸ *Id.* at 245-46.

⁵⁹ *Id.* at 246.

clearly serves one of the fundamental purposes of the Exchange Act—to “preserv[e] the integrity of the securities markets.”⁶⁰ As the Second Circuit stated so well in *In re Ames Department Stores Inc. Stock Litigation*, “[h]owever we deal with the more difficult cases . . . we should not let them affect our understanding that ordinary securities frauds . . . fall well within the Rule.”⁶¹

Although the Supreme Court in *O’Hagan* and *Zandford* does not appear to have articulated a standard to be applied broadly to Rule 10b-5’s “in connection with” requirement, the Court in those two cases, as well as in *Bankers Life*, did describe some general parameters for evaluating the requirement’s reach. First, the Rule must be “construed ‘not technically and restrictively, but flexibly to effectuate its remedial purposes.’”⁶² Second, while Rule 10b-5 is designed to “protect[t] the integrity of the securities markets,”⁶³ its remedial purposes reach beyond that goal.⁶⁴ Therefore, Rule 10b-5’s “in connection with” requirement can be met even if a “transaction is not conducted through a securities exchange or an organized over-the-counter market.”⁶⁵ Third, the fraud need not relate to the price or value of a security.⁶⁶ Fourth, a fraud can be “in connection with” the purchase or sale of securities even if the deception is not perpetrated on a party to the transaction.⁶⁷ Finally, whether a state law remedy is available is irrelevant to determining the scope of the Rule.⁶⁸

B. Varying Approaches of the Courts of Appeals

With such little concrete guidance from the Supreme Court, lower courts have struggled to establish a consistent approach to Rule 10b-5’s “in connection with” requirement.⁶⁹ As the United States Court of Appeals for the Fifth Circuit noted in

⁶⁰ Sec. & Exch. Comm’n v. *Zandford*, 535 U.S. 813, 821 (2002).

⁶¹ *In re Ames Dep’t Stores Inc. Stock Litig.*, 991 F.2d 953, 966 (2d Cir. 1993).

⁶² *Zandford*, 535 U.S. at 819 (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (quoting *Sec. & Exch. Comm’n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963))); see *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (“Section 10(b) must be read flexibly, not technically and restrictively.”).

⁶³ *United States v. O’Hagan*, 521 U.S. 642, 653 (1997).

⁶⁴ See *Zandford*, 535 U.S. at 821-22 (noting that, although *Bankers Life* “recognized that the interest in ‘preserving the integrity of the securities markets’ was one of the purposes animating [§ 10(b), it] rejected the notion that § 10(b) is limited to serving that objective alone.” (citing *Bankers Life*, 404 U.S. at 12)); *Bankers Life*, 404 U.S. at 12 (“[Section] 10(b) . . . is not limited to preserving the integrity of the securities markets, though that purpose is included.” (internal quotations omitted)).

⁶⁵ *Bankers Life*, 404 U.S. at 10.

⁶⁶ *Zandford*, 535 U.S. at 822; *Bankers Life*, 404 U.S. at 12.

⁶⁷ See *O’Hagan*, 521 U.S. at 658 (indicating that Section 10(b) “requires deception ‘in connection with the purchase or sale of a security,’ not deception of an identifiable purchaser or seller”).

⁶⁸ *Bankers Life*, 404 U.S. at 12.

⁶⁹ See *Fletcher*, *supra* note 33, at 91 (indicating that “there has been only confusion” in applying the “in connection with” requirement to different scenarios); Francesca Muratori, *The Boundaries of the “In Connection With” Requirement of Rule 10b-5: Should Advertising*

Roland v. Green, “[e]ach of the circuits that has tried to contextualize the ‘coincide’ requirement has come up with a slightly different articulation of the requisite connection between the fraud alleged and the purchase or sale of securities (or representations about the purchase or sale of securities).”⁷⁰

The United States Court of Appeals for the Third Circuit, for example, historically has required a causal connection—*i.e.*, to have a transactional nexus, the fraud must have caused the securities transaction.⁷¹ The Fifth Circuit, on the other hand, has indicated expressly that a causal connection is not required⁷² and, along with United States Court of Appeals for the Ninth Circuit, applies a vague standard, one under which the “in connection with” requirement is met when the fraud and the securities transaction are “more than tangentially related.”⁷³

Most circuit courts have taken to heart the Supreme Court’s admonition that Rule 10b-5 is to be construed flexibly and have not adopted any fundamental principle for applying the “in connection with” requirement. Instead, they—to varying extents—have considered the “in connection with” requirement to be met in a variety of circumstances, such as when a securities transaction was necessary to complete the fraud,⁷⁴ when the fraud actually caused or induced a securities transaction,⁷⁵ and

be Actionable as Securities Fraud?, 56 BUS. LAW. 1057, 1061 (suggesting that the Supreme Court’s lack of clear guidance has resulted in a “state of confusion, an outcome of inconsistent judicial treatment in the absence of prevailing interpretive principles”).

⁷⁰ *Roland v. Green*, 675 F.3d 503, 514 (5th Cir. 2012).

⁷¹ *See Semerenko v. Cendant Corp.*, 223 F.3d 165, 175 (3d Cir. 2000) (noting that the court previously had concluded that the “in connection with” language requires a causal connection between the claimed fraud and the purchase or the sale of a security”). Strangely, *Rowinski* makes no mention of a causal connection, leaving one to wonder whether the Third Circuit has decided to abandon the requirement. *See generally Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294 (3d Cir. 2005) (applying a multi-factor test for the “in connection with” requirement, but not indicating that a causal connection is required).

The Seventh and Tenth Circuits also have required a causal connection. *See Sec. & Exch. Comm’n v. Jakubowski*, 150 F.3d 675, 680 (7th Cir. 1998) (“Many of this court’s cases say that a misrepresentation can be ‘in connection with’ the purchase or sale of securities only if it influences an investment decision.”); *Sec. & Exch. Comm’n v. Wolfson*, 539 F.3d 1249, 1262 (10th Cir. 2008) (“[T]his interpretation of the ‘in connection with’ element is consistent with the Supreme Court’s relatively broad construction and our circuit’s own requirement that there be a causal connection between the fraud and the injury.”).

⁷² *See Green*, 675 F.3d at 519 (“By tying the ‘coincide’ requirement to ‘inducement,’ it unnecessarily imports causation into a test whose language (‘coincide’) specifically disclaims it.”).

⁷³ *Id.* at 520; *see also Madden v. Cowen & Co.*, 576 F.3d 957, 965-66 (9th Cir. 2009) (“Under our Section 10(b) cases, a misrepresentation is ‘in connection with’ the purchase or sale of securities if there is ‘a relationship in which the fraud and the stock sale coincide or are more than tangentially related.’” (quoting *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1131 (9th Cir. 2002))).

⁷⁴ *See, e.g., Romano v. Kazacos*, 609 F.3d 512, 522 (2d Cir. 2010) (“SLUSA’s ‘in connection with’ standard is met where plaintiff’s claims ‘turn on injuries caused by acting on misleading investment advice’—that is, where plaintiff’s claims ‘necessarily allege,’ ‘necessarily involve,’ or ‘rest on’ the purchase or sale of securities.” (quoting *Dabit v. Merrill Lunch, Fenner & Smith, Inc.*, 395 F.3d 25, 48, 50 (2d Cir. 2005))); *Segal v. Fifth Third Bank*,

when the defendant intended to induce a securities transaction or influence an investment decision or knew that the fraud would do so.⁷⁶

The Fourth Circuit in *Pirate Investor* admirably attempted to provide some structure to its transactional nexus analysis by adopting a specific test that

N.A., 581 F.3d 305, 310 (6th Cir. 2009) (“Segal’s allegations do not merely ‘coincide’ with securities transactions; they depend on them.” (quoting *Siepel v. Bank of Am.*, 526 F.3d 1122, 1124 (8th Cir. 2008)); *Sofonia v. Principal Life Ins. Co.*, 465 F.3d 873, 879 (8th Cir. 2006) (“The alleged fraudulent conduct was, therefore, an integral step in [Sofonia’s] exchange of his membership interest for PFG stock and the present action satisfies the ‘in connection with’ requirement for SLUSA preemption.” (internal citations omitted)); *Instituto de Prevision Militar v. Merrill Lynch*, 546 F.3d 1340, 1349 (11th Cir. 2008) (“The question here, then, is whether the second amended complaint alleges . . . fraud that induced IPM to invest with PFA . . . or a fraudulent scheme that coincided and *depended upon* the purchase or sale of securities” (emphasis added)).

⁷⁵ See, e.g., *Romano*, 609 F.3d at 522 (“We have also found that the more exacting ‘induced’ standard satisfies § 10(b)’s ‘in connection with’ requirement.” (citing *Press v. Chem. Invest. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) and *United States v. Ostrander*, 999 F.2d 27, 32-33 (2d Cir. 1993)); *Jakubowski*, 150 F.3d at 680 (“[A] causal connection . . . between the misrepresentation and a securities transaction satisfies § 10(b) and Rule 10b-5.”); *Wolfson*, 539 F.3d at 1262 (10th Cir. 2008) (“In this circuit, we have held that this element requires only that there be ‘a causal connection between the allegedly deceptive act or omission and the alleged injury.’” (quoting *Arst v. Stifel, Nicolaus & Co. Inc.*, 86 F.3d 973, 977 (10th Cir. 1996)); *Instituto*, 546 F.3d at 1349 (“The question here, then, is whether the second amended complaint alleges . . . fraud *that induced* IPM to invest with PFA . . . or a fraudulent scheme that coincided and depended upon the purchase or sale of securities” (emphasis added)).

⁷⁶ See, e.g., *Ostrander*, 999 F.2d at 32-33 (2d Cir. 1993) (“Any payment to a portfolio manager intended to induce the purchase of a firm’s securities on behalf of an investment company easily qualifies as a ‘fraudulent, deceptive or manipulative’ act ‘in connection with’ the investment company’s acquisition of securities.”); *Semerenko*, 223 F.3d at 177 (3d Cir. 2000) (finding that whether an accountant “knew or . . . had reason to know” its audit report would be used in making a tender was critical to the “in connection with” requirement as to the audit report); *Jakubowski*, 150 F.3d at 679 (“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?’”); *Sofonia*, 465 F.3d at 880 (“Any fraudulent statements allegedly made . . . to persuade policyholders to approve this transaction most assuredly were made ‘in connection with’ the policyholders’ purchase of PFG common stock.”); *McGann v. Ernst & Young*, 102 F.3d 390, 397 (9th Cir. 1996) (“While an outside accounting firm might be blameless where it had no reason to know that its client would use its audit report to sell securities, . . . the instant plaintiffs squarely alleged that E&Y knew that CPC would include its audit opinion in a Form 10-K.”); *Sec. & Exch. Comm’n v. Rana Research, Inc.*, 8 F.3d 1358, 1362-63 (9th Cir. 1993) (“Moreover, Sahgal intended to affect the market for Superior’s stock Statements ‘calculated’ to influence investors meet the ‘in connection with’ requirement.”); *Wolfson*, 539 F.3d at 1251 (“[W]hen a non-employee consultant causes misstatements or omissions within periodic financial reports submitted to the Commission, knowing that those misstatements or omissions will reach investors, he can be held primarily liable under the antifraud provisions of the federal securities laws.”); *United Int’l Holdings, Inc. v. Wharf (Holdings) Ltd.*, 210 F.3d 1207, 1221 (10th Cir. 2000) (“The representations allegedly were made to induce UIH to purchase the option. As such, the misrepresentations were made to influence UIH’s investment decision and were made in connection with the purchase or sale of a security.”).

considered four factors, which “serve to guide the inquiry” and are neither exclusive nor mandatory.⁷⁷ As indicated above, one of the factors, which the Fourth Circuit took from *Zandford*, is “whether a securities sale was necessary to the completion of the fraudulent scheme.”⁷⁸ The other three factors, which the court drew from cases decided by the Third and Tenth Circuits, are “whether the parties’ relationship was such that it would necessarily involve trading in securities”⁷⁹; “whether the defendant intended to induce a securities transaction”⁸⁰; and “whether material misrepresentations were disseminated to the public in a medium upon which a reasonable investor would rely.”⁸¹

C. Publicly Disseminated Information Principles

The fourth factor in *Pirate Investor*’s multi-factor test originates from Rule 10b-5 cases involving false or misleading information disseminated to the public. In light of the typical broad distribution of advertisements, it is within this context that advertisements properly are considered.

SEC v. Texas Gulf Sulphur Co. is a significant early case that addressed the question of when misleading statements disseminated to the public meet the “in connection with” requirement.⁸² In *Texas Gulf Sulphur*, the Second Circuit considered whether an allegedly misleading press release made by a corporation not engaged in a securities transaction met the requirement.⁸³ Based on the legislative history of Exchange Act § 10(b), the court concluded that the alleged fraud was indeed within the scope of Rule 10b-5, holding that a misrepresentation is “in connection with” a securities transaction if it is made “in a manner reasonably calculated to influence the investing public.”⁸⁴

The Second Circuit’s use of the phrase “reasonably calculated” suggests that the “in connection with” element is met only when the person communicating intended to influence investors. The opinion indicates, however, that intent is not required⁸⁵

⁷⁷ See Sec. & Exch. Comm’n v. *Pirate Investor*, 580 F.3d 233, 244 (4th Cir. 2009) (“[W]e do not presume to exclude other factors that could help distinguish between fraud in the securities industry and common law fraud that happens to involve securities.”). The Third Circuit in *Rowinski* employed a similar multi-factor test. See *Rowinski v. Salomon Smith Barney, Inc.*, 398 F.3d 294, 302 (3d Cir. 2005) (articulating a multi-factor test).

⁷⁸ *Pirate Investor*, 580 F.3d at 244 (citing Sec. & Exch. Comm’n v. *Zandford*, 535 U.S. 813, 820-21 (2002)).

⁷⁹ *Id.* at 244 (citing *Rowinski*, 398 F.3d at 302-03).

⁸⁰ *Id.* (citing *Wharf*, 210 F.3d at 1221).

⁸¹ *Id.* (citing *Semerenco*, 223 F.3d at 176).

⁸² Sec. & Exch. Comm’n v. *Tex. Gulf Sulphur Co.*, 401 F.2d 833, 861 (2d Cir. 1968); see *In re Ames Dep’t. Stores, Inc. Stock Litig.*, 991 F.2d 953, 965 (2d Cir. 1993) (describing *Texas Gulf Sulphur* as a case of “great significance”).

⁸³ *Tex. Gulf Sulphur*, 401 F.2d at 839-42.

⁸⁴ *Id.* at 862.

⁸⁵ *Id.* at 860 (“There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they . . . acted with wrongful motives.”); *id.* at 860-61 (“Congress intended to protect the investing public in connection with their purchases and sales on Exchanges from being

and that Congress “intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and in connection therewith, so relying, cause them to purchase or sell a corporation’s securities.”⁸⁶ In reaching this conclusion, the court focused on the fact that the investing public is harmed by false or misleading statements regardless of their purpose.⁸⁷

The Supreme Court in *Basic* quoted *Texas Gulf Sulphur*’s test for the “in connection with” requirement when the Court considered the materiality of merger discussions, but the Court “has never squarely addressed the validity of the *Texas Gulf* test.”⁸⁸ Lower courts nonetheless have continued to apply *Texas Gulf Sulphur* to cases in which information is publicly disseminated and have found that the requisite connection may be met with respect to SEC filings, press releases, public statements, letters published in the financial press, news articles, investment research reports, and product advertisements.⁸⁹

The Second Circuit in its 1993 decision in *Ames* suggested that “the lesson [from *Texas Gulf Sulphur*] seems to be that any material information issued by a corporation (whose securities are publicly traded) has appropriate ‘connection’ to constitute a 10b-5 violation if the information is misleading.”⁹⁰ The principle the court applied in *Ames*, however, was somewhat narrower:

[W]hen the fraud alleged is that the plaintiff bought or sold a security in reliance on misrepresentations as to its value, made by a defendant whose

misled by misleading statements promulgated for or on behalf of corporations irrespective of whether . . . the corporation or its management have an ulterior purpose in making an official release.”). *But see* Fletcher, *supra* note 33, at 935 (concluding, based on *Texas Gulf Sulphur*, that “in cases in which a misleading statement was made without contemplation by the party disseminating the statement that the investing public rely thereon, even when the public might have actually relied on the misstatements, courts have held that the necessary connection . . . is absent”).

⁸⁶ *Tex. Gulf Sulphur*, 401 F.2d at 860.

⁸⁷ *Id.* at 861.

⁸⁸ *McGann v. Ernst & Young*, 102 F.3d 390, 393; *see also* *Basic v. Levinson*, 485 U.S. 185, 235 n.13 (1988).

⁸⁹ *Rowinski v. Salomon Smith Barney, Inc.*, 398 F.3d 294, 297, 302 (3d Cir. 2005) (finding that misrepresentations in investment research reports meet the “in connection with” requirement); *Semerenco v. Cendant Corp.*, 223 F.3d 165, 170-71 (3d Cir. 2000) (remanding case for determination as to whether public statements, a letter to shareholders published in the financial press, and periodic SEC filings met the “in connection with” requirement); *McGann*, 102 F.3d at 397 (finding that an audit report included in an SEC filing meets the “in connection with” requirement when the auditor knows it will be included in the filing); *Sec. & Exch. Comm’n v. Rana Research*, 8 F.3d 1358, 1362 (9th Cir. 1993) (finding that issuance of press release, “coupled with the public trading” in related securities, satisfies the “in connection with” requirement); *Sec. & Exch. Comm’n v. Wolfson*, 539 F.3d 1249, 1262-63 (10th Cir. 2008) (concluding that periodic SEC filings were “in connection with” securities transactions); *In re Ames Dept. Stores, Inc. Stock Litig.*, 991 F.2d 953, 968 (2d Cir. 1993) (determining that statements in press releases, periodic filings, and news articles may meet the “in connection with” requirement); *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153, 156-57 (2d Cir. 1998) (concluding that advertisements in medical journals may meet the “in connection with” requirement).

⁹⁰ *Ames*, 991 F.2d at 965.

position made it reasonable for the plaintiff to rely on the representation and imposed some duty on the defendant to be honest or to disclose information, then whatever problems there may be with the case, a connection between the fraud and the transaction should not be one of them.⁹¹

Similarly, the Third, Ninth, and Tenth Circuits have indicated that, for publicly disseminated information, a mere causal connection between the information and a securities transaction satisfies Rule 10b-5's transactional nexus requirement.⁹² According to the Third Circuit, to meet the "in connection with" requirement, a plaintiff need only show that the information was material when it was disseminated and that it was "disseminated in a medium upon which a reasonable investor would rely."⁹³ In adopting this rule, the Third Circuit explained:

The purpose underlying § 10(b) and Rule 10b-5 is to ensure that investors obtain fair and full disclosure of material facts in connection with their decisions to purchase or sell securities. That purpose is best satisfied by a rule that recognizes the realistic causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities.⁹⁴

Because materiality is a separate element of a Rule 10b-5 claim,⁹⁵ for the Second, Third, Ninth, and Tenth Circuits, the "in connection with" test for publicly disseminated information appears to boil down to whether the means by which the information is disseminated is one on which a reasonable investor would rely. The opinions from Third and Tenth circuits, however, suggest that intent (or more generally, state of mind) may be an important—perhaps critical—consideration.⁹⁶ In

⁹¹ *Id.* at 967.

⁹² *See Semerenko*, 223 F.3d at 176 ("The purpose underlying § 10(b) and Rule 10b-5 . . . is best satisfied by a rule that recognizes the realistic causal effect that material misrepresentations . . . tend to have on the investment decisions of market participants who trade in those securities."); *Rana Research*, 8 F.3d at 1362 ("Where the fraud alleged involves public dissemination in a document . . . on which an investor would presumably rely, the 'in connection with' requirement is generally met by proof of the means of dissemination and the materiality of the misrepresentation or omission."); *Wolfson*, 539 F.3d at 1262 ("[S]everal of our sister circuits have recognized that '[w]here the fraud alleged involves public dissemination in a document . . . on which an investor would presumably rely, the 'in connection with' requirement is generally met by proof of the means of dissemination and the materiality of the misrepresentation or omission.'" (quoting *Rana Research*, 8 F.3d at 1362 (citing *Semerenko*, 223 F.3d at 176, and *Sec. & Exch. Comm'n v. Savoy Indus., Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978))))).

⁹³ *Semerenko*, 223 F.3d at 176.

⁹⁴ *Id.* (internal citations omitted).

⁹⁵ *See supra* note 20 and accompanying text (noting that, to be successful in a Rule 10b-5 action, one must establish that the defendant made a *material* misstatement or omission).

⁹⁶ For the Third Circuit in *Semerenko*, whether an auditor "knew or had reason to know" that its audit report was to be disseminated publicly is critical to determining whether the report meets Rule 10b-5's transactional nexus requirement. *Semerenko*, 223 F.3d at 177. The

Semerenko v. Cendant Corp., the Third Circuit “pointed out that, under the standard which [it had] adopt[ed], the [plaintiffs were] not required to establish that the defendants actually envisioned that [the plaintiffs] would rely upon the alleged misrepresentations when making their investment decisions. Rather, [they] must only show that the alleged misrepresentations were reckless.”⁹⁷ The court therefore seems to indicate that, to meet the “in connection with” requirement, a plaintiff needs to establish either that the defendant intended that the plaintiff would rely on the misrepresentations or were reckless in not knowing that they would. Similarly, the Tenth Circuit in *SEC v. Wolfson* indicated that it is the intent of the defendant that justifies the consideration of the medium in which information is disseminated. According to the court, “because such documents are *designed* to reach investors and to influence their decisions to transact in a publicly-traded security, any misrepresentations contained within the documents are made “in connection with” the purchase or sale of that security.”⁹⁸

In a number of circuits, then, whether the “in connection with” requirement is met in public dissemination cases turns on causation or a combination of causation and intent. For the “in connection with” requirement to be met, the relevant false or misleading statement must be disseminated through a means on which a reasonable investor would rely and, perhaps in the Third and Tenth Circuits, the person disseminating the information must have intended to influence, or have been reckless in not knowing that it could influence, the investing public.⁹⁹

Second Circuit in *Ames* and the Ninth Circuit in *Rana Research* seem to indicate that evidence of the defendant’s intent might lend support in finding that the requisite transactional nexus exists, but that it is not necessary to meet its test for publicly disseminated information. See *Ames*, 991 F.2d at 965 (noting that, not only had the defendants ignored the “well-established rule” that Rule 10b-5 proscribes reckless behavior, but also that they “fail[ed] to acknowledge that [the documents at issue in the cases were] precisely the sort of documents which a reasonable investor would consider in evaluating a company’s prospects.”); *Rana Research*, 8 F.3d at 1362-63 (“Moreover, Sahgal intended to affect the market for Superior’s stock, as evidenced by his statement that he issued the release in part to ‘pressure’ Borick to present the offer to Superior’s board of directors. Statements ‘calculated’ to influence investors meet the ‘in connection with’ requirement.” (quoting *Sec. & Exch. Comm’n v. Hasho*, 780 F. Supp. 1059, 1106 (S.D.N.Y. 1992))).

⁹⁷ *Semerenko*, 223 F.3d at 176 (internal citations omitted).

⁹⁸ *Wolfson*, 539 F.3d at 1262 (quoting *Rana Research*, 8 F.3d at 1362 (emphasis added)). The Tenth Circuit in *Wolfson* cites its decision in *Wharf* to support adopting a test for publicly disseminated information adopted by the Second, Third, and Ninth Circuits. *Id.* at 1262 (citing *United Int’l Holdings, Inc. v. Wharf*, 210 F.3d 1207, 1221 (10th Cir. 2000)). Because the requisite transactional nexus found in *Wharf* was based on intent, *Wolfson*’s citation of *Wharf* lends further support to the importance of intent in determining whether publicly disseminated misstatements or misleading statements are “in connection with” a securities transaction. See *Wharf*, 210 F.3d at 1221 (“The representations allegedly *were made to induce* UIH to purchase the option. As such, the misrepresentations *were made to influence* UIH’s investment decision and were made in connection with the purchase or sale of a security.” (emphasis added)).

⁹⁹ In 1989, Fletcher identified these two approaches as the ones generally taken in cases involving issuers who make misrepresentations, but who are not engaging in securities transactions. Fletcher, *supra* note 33, at 932-36.

III. HISTORICAL CONSIDERATION OF ADVERTISEMENTS AND THE “IN CONNECTION WITH” REQUIREMENT

A. Advertising Cases

Only three cases specifically have addressed whether a misrepresentation or omission in a product advertisement can be considered “in connection with” a securities transaction for purposes of Rule 10b-5.¹⁰⁰ The first case was *Ross v. A.H. Robins Co., Inc.*, in which the United States District Court for the Southern District of New York considered whether Rule 10b-5 applied to allegedly false and misleading statements about the Dalkon Shield intrauterine device that were made by A.H. Robins Co., Inc., in advertisements directed to medical providers and in patient brochures.¹⁰¹ The district court determined that the Rule did not apply because the statements did not satisfy the “in connection with” requirement.¹⁰²

The defendants in *Ross* looked to *Texas Gulf Sulphur* for their defense.¹⁰³ Specifically, they asserted that the “in connection with” requirement is met only when allegedly fraudulent statements “are made in a manner reasonably calculated to influence the investing public such as by means of the financial media,” and that the Robins advertisements and brochures were “calculated only to influence the medical decisions of doctors and their patients.”¹⁰⁴ The district court in *Ross* agreed and dismissed the plaintiffs’ claims with respect to the advertisements and brochures.¹⁰⁵ The court noted that, in *Texas Gulf Sulphur*, the medium in which the statements are made is important—it must be a medium upon which reasonable investors would rely.¹⁰⁶ The advertisements and brochures, the court determined, were not such media.¹⁰⁷ Moreover, the court observed that even the plaintiffs had agreed that the advertisements and brochures “were [not] issued to induce purchases of Robins securities,” but instead asserted that “the circulation and dissemination of said false advertisements and patient brochures . . . had the effect of . . . inflat[ing] the price of Robins’ stock.”¹⁰⁸ According to the court, then, the plaintiffs had not alleged a

¹⁰⁰ Muratori noted in 2001 that “[t]here is a dearth of reported cases involving corporate marketing.” Muratori, *supra* note 69, at 1062. Indeed, there have not been any reported cases since then.

¹⁰¹ *Ross v. A.H. Robins Co.*, No. 77 Civ. 1409, 1978 WL 1078, at *1-2 (S.D.N.Y. Apr. 6, 1978).

¹⁰² *Id.* at *4 (“The Court finds that plaintiffs have not posited a sufficient causal nexus to make claims based on the advertisements and patient brochures.”).

¹⁰³ *Id.* at *10.

¹⁰⁴ *Id.* at *9.

¹⁰⁵ *Id.* at *10.

¹⁰⁶ *Id.* at *7-8.

¹⁰⁷ *Id.* at *10 (“The Court finds that plaintiffs have not posited a sufficient causal nexus to make the claims based on the advertisements and patient brochures actionable under Rule 10b-5.”).

¹⁰⁸ *Id.* at *9.

“sufficient causal nexus” for purposes of Rule 10b-5’s “in connection with” requirement.¹⁰⁹

In *Hemming v. Alfin Fragrances, Inc.*, the New York district court returned to the question of whether misstatements in a product advertisement may be considered “in connection with” a securities transaction. The plaintiffs in *Hemming* claimed that an advertisement, brochure, and pamphlet, as well as video-screen displays at department stores, made false representations about Glycel, a skin care product sold by Alfin Fragrances, Inc.¹¹⁰ According to the plaintiffs, the false representations were actionable under Rule 10b-5 because the defendants “were directing their statements to investors in order to promote sales of stock” and the statements had inflated the price of Alfin’s stock at the time they purchased their shares.¹¹¹

The defendants responded that the plaintiffs’ claims were ones of false advertising not securities fraud, and the district court agreed.¹¹² In reaching its decision, the court noted that the Second Circuit previously had stated that

[t]he purpose of § 10(b) and Rule 10(b)(5) is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.¹¹³

For the court in *Hemming*, the content of the advertising materials and their purpose was critical. According to the court, the advertisement “concern[ed] Glycel’s qualities as a skin care treatment, not as an investment choice.”¹¹⁴ The brochure and pamphlet, the court asserted, were directed to consumers, not investors, and “[i]t would distort the meaning of rule 10(b)(5) to allow such materials to serve as a basis for liability.”¹¹⁵

The *Hemming* court’s decision once again reflects an emphasis on the medium or context in which statements are made. This emphasis is particularly evident from the fact that, while the court dismissed the plaintiffs’ claims as to the marketing materials, it refused to do so as to claims relating to press releases and a presentation to investment analysts that included statements similar to those in the advertising materials.¹¹⁶

¹⁰⁹ *Id.*

¹¹⁰ *Hemming v. Alfin Fragrances, Inc.*, 690 F. Supp. 239, 241-42 (S.D.N.Y. 1988).

¹¹¹ *Id.* at 241.

¹¹² *Id.*

¹¹³ *Id.* (quoting *Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984), *cert. denied*, 469 U.S. 884 (1984)).

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 244-45.

¹¹⁶ *Id.* at 241, 245 (noting that, although the substance of statements allegedly included in two press releases and made to a group of investment analysts at a luncheon was similar to those alleged with respect to the advertising materials, the former statements were “directed towards the financial community.”).

The Second Circuit was the first—and has been the only—court of appeals to consider whether a false or misleading product advertisement could meet Rule 10b-5's "in connection with" requirement. It did so in *In re Carter-Wallace, Inc. Securities Litigation*, a case in which the plaintiffs alleged that Carter-Wallace, Inc. had violated Rule 10b-5 by making false statements about Felbatol, an anti-epileptic drug, in advertisements placed in two medical journals.¹¹⁷ *Carter-Wallace* involved an appeal from the United States District Court for the Southern District of New York, which had found *as a matter of law* that statements in advertisements published in medical journals do not satisfy Rule 10b-5's transactional nexus requirement.¹¹⁸

The Second Circuit reversed the district court's ruling and held that "false advertisements in technical journals may be 'in connection with' a securities transaction if the proof at trial establishes that the advertisements were used by market professionals in evaluating the stock of the company."¹¹⁹ The plaintiffs had used a fraud-on-the-market theory to argue that Carter-Wallace's false statements had an impact on the price at which they purchased Carter-Wallace common stock.¹²⁰ The Second Circuit was persuaded by the plaintiffs' argument and determined that a "cause and effect" test applies with respect to the "in connection with" requirement in a fraud-on-the-market case.¹²¹ Under this test, the transactional nexus requirement is met if "statements which manipulate the market are connected to resultant stock trading."¹²²

The Second Circuit concluded that Carter-Wallace's Felbatol advertisements could meet the test. It observed:

That the market can absorb technical medical information is neither novel nor surprising. Technical information about the medical efficacy of new drugs, whether found in advertisements or elsewhere, has an obvious bearing on the financial future of a drug company. In an economy that produces highly sophisticated products, technical information is of enormous importance to financial analysts The fact that such information is found in a specialized medical journal, as here, rather than in a statement addressed to participants in financial markets . . . seems to us irrelevant, so long as the journals are used by analysts studying the prospects of drug companies. In fact, an analyst might consider such an advertisement more informative than a non-technical but corresponding statement to financial market professionals.¹²³

¹¹⁷ *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153, 154 (2d Cir. 1998).

¹¹⁸ *Id.* at 154.

¹¹⁹ *Id.* at 156-57.

¹²⁰ *Id.* at 156.

¹²¹ *Id.*

¹²² *Id.* (quoting *In re Ames Dep't Stores Inc. Stock Litig.*, 991 F.3d 953, 966 (2d Cir. 1993)).

¹²³ *Id.* (internal citations omitted).

With this in mind, the court distinguished *Ross*. It noted that *Ross* was decided before *Basic*,¹²⁴ in which the Supreme Court had determined that the “fraud-on-the-market theory” was a viable consideration in determining whether the reliance element for a private cause of action under Rule 10b-5 is met.¹²⁵ Although the court in *Carter-Wallace* did not say so explicitly, it concluded that the fraud-on-the-market theory was equally relevant to the “in connection with” requirement and therefore *Ross*’s limitation on the requirement no longer was appropriate.

B. Criticism of Carter-Wallace

Francesca Muratori in a 2001 article sharply criticized the *Carter-Wallace* decision.¹²⁶ Muratori claimed, among other things, that the Second Circuit had not considered adequately the lower court decisions in *Ross* and *Hemming* and that its decision departed from its precedent.¹²⁷

According to Muratori, the Second Circuit was wrong to look to *Basic* in distinguishing *Ross* because reliance was at issue in *Basic*, not the transactional nexus requirement. The Second Circuit, she asserted, had conflated the two elements without any meaningful discussion.¹²⁸ Furthermore, she disapprovingly observed that the Second Circuit had completely ignored *Hemming*, which was decided after *Basic*.¹²⁹ If the Second Circuit had addressed *Hemming*, Muratori argued, it would have been forced to consider the fact that consumers, not investors, are the target audience for product advertisements.¹³⁰

Arguing that the Second Circuit’s decision was inconsistent with its precedent, Muratori focused in particular on *Ames* and noted that the communication in that case, unlike the advertisements in *Carter-Wallace*, were aimed at investors.¹³¹ *Carter-Wallace*, she asserted, expanded the “in connection with” requirement beyond *Ames* to communications outside of the investment context.¹³²

Muratori strongly favored the district court’s decision in *Carter-Wallace* that statements in advertisements are outside the scope of Rule 10b-5 as a matter of law.¹³³ She argued that “[t]he universally understood nature of advertising, its importance to the health of our economy, and the fact that it is not directed at investors all warrant placing advertising outside the scope of the federal securities laws.”¹³⁴ Moreover, she asserted that the securities laws do not need to protect

¹²⁴ *Id.*

¹²⁵ See *Basic v. Levinson*, 485 U.S. 224, 250 (1988) (“It is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory.”).

¹²⁶ Muratori, *supra* note 69, at 1061.

¹²⁷ *Id.* at 1073-74, 1076.

¹²⁸ *Id.* at 1073.

¹²⁹ *Id.* at 1074.

¹³⁰ *Id.*

¹³¹ *Id.* at 1076.

¹³² *Id.*

¹³³ *Id.* at 1081.

¹³⁴ *Id.*

investors with respect to advertisements because advertising is inherently “less than truthful”¹³⁵ and “no reasonable investor” would rely exclusively on statements in advertising to make investment decisions.¹³⁶ According to Muratori, it is even less likely that financial analysts would rely on statements made in advertisements without independent verification.¹³⁷ As a result, she claimed, the market price of a company’s securities would not be affected by false statements in advertisements.¹³⁸ Therefore, those purchasing at the market price would not be harmed by such false statements.

IV. ADVERTISEMENTS MAY MEET THE “IN CONNECTION WITH” REQUIREMENT

A. Publicly Disseminated Information Principles Allow for Advertisements to Meet the “In Connection With” Requirement

While Muratori was correct that the communications in *Ames* were directed toward the investing public, the Second Circuit in *Ames* did not purport to limit application of Rule 10b-5 to publicly disseminated information directed to investors.¹³⁹ In fact, the court noted that it previously had “recognize[d] that statements directed to the general public which affect the public’s interest in the corporation’s stock are made in connection with sales or purchases of that stock.”¹⁴⁰

Moreover, based on *Ames*, the Second Circuit rightfully looked to *Basic* to distinguish *Ross*. In *Ames*, the Second Circuit recognized that *Basic* was not addressing the “in connection with” requirement, but materiality and reliance.¹⁴¹ Nevertheless, it viewed *Basic* as instructive as to Rule 10b-5’s transactional nexus requirement:

While *Basic Inc.* addressed the reliance and materiality requirements, rather than the connection requirement, the fraud on the market theory is premised on the notion that fraud can be committed by any means of disseminating false information into the market on which a reasonable investor would rely. Because the fraud on the market may taint each purchase of the affected stock, each purchaser who is thereby defrauded (and, since the presumption is rebuttable, not all purchasers necessarily are defrauded by the information) is defrauded by reason of the publicly disseminated statement. If such a straightforward cause and effect is not a connection, then the Rule would not punish a particularly effective means

¹³⁵ *Id.* at 1080.

¹³⁶ *Id.* at 1081.

¹³⁷ *Id.*

¹³⁸ *Id.* at 1082 (“Those few unreasonable investors who do base their investment decisions on information found in advertisements will be inconsiderable and their collective action trivial. As such, it will not affect market price.”).

¹³⁹ See *In re Ames Dep’t Stores Inc. Stock Litig.*, 991 F.2d 953, 967 (2d Cir. 1993) (noting that it was not “commenting on how to analyze the more difficult cases”).

¹⁴⁰ *Id.* at 966 (referring to *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980)).

¹⁴¹ *Id.* at 967.

of reducing the integrity of, and public confidence in, the securities markets.¹⁴²

Whatever may be said about the propriety of treating the “in connection with” requirement in a manner similar to reliance, *Carter-Wallace*’s doing so was consistent with what the Second Circuit had done previously.

Cases more recent than *Ames* and *Carter-Wallace* that address the “in connection with” requirement and publicly disseminated information certainly allow for statements in advertising materials to meet the transactional nexus requirement. As indicated above, the tests adopted by the Third, Ninth, and Tenth Circuits, consistent with the Second Circuit’s approach, look to whether the medium in which a public statement is made is one on which investors reasonably would rely. They do not exclude—at least not wholesale—publicly disseminated information that primarily is directed to or used by an audience other than investors. Whether false or misleading statements in product advertisements may meet the “in connection with” requirement, then, depends on whether investors reasonably rely on advertisements in making investment decisions.

B. Empirical Studies Indicate that Product Advertising Affects Investor Decisions and that Managers Use Advertising for that Purpose

Muratori argued that companies do not target investors when they advertise their products and that “no reasonable investor” would rely exclusively on an advertisement in making an investment decision.¹⁴³ She further asserted that “[t]hose few unreasonable investors who do base their investment decisions on information found in advertisements will be inconsiderable and their collective action trivial.”¹⁴⁴ If Muratori’s assertions were correct when her article was published in 2001, recent empirical studies suggest that they are not today.¹⁴⁵

¹⁴² *Id.*

¹⁴³ Muratori, *supra* note 69, at 1081.

¹⁴⁴ *Id.* at 1082.

¹⁴⁵ See Dong Lou, Attracting Investor Attention Through Advertising 8 (Nov. 2011) (working paper) [hereinafter Lou, Attracting Investor Attention], available at http://personal.lse.ac.uk/loud/advertising_20111110.pdf (“The main contribution of this paper is to explicitly link the temporary return effect of advertising to managers’ objective to maximize the proceeds from insider sales and other forms of equity sales.”); Amit Joshi & Dominique M. Hanssens, *The Direct and Indirect Effects of Advertising Spending on Firm Value*, 74 J. MARKETING 20, 30 (Jan. 2010) (“This study provides conceptual and empirical evidence of a positive relationship between advertising expenditures and the market value of firms.”); Thomas Chemmanur & An Yan, Advertising, Attention, and Stock Returns 34 (Feb. 2009) (working paper series), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1340605 (“Overall, our results suggest that advertising helps a firm attract investors’ attention in the advertising year. The attracted attention increases stock price in the advertising year.”); Shuba Srinivasan et al., Product Innovations, Advertising and Stock Returns 24 (May 7, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1136319 (“We find that the stock-return impact of new-product introductions is higher when they are backed by substantial advertising investments. In other words, communicating the differentiated added value to consumers yields higher firm-value effects of innovations, especially for pioneering innovations. . . .”); Dong Lou, Maximizing Short-Term Stock Prices Through Advertising 26 (Nov. 2010) (working paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571947 (finding a “significant rise in stock price

A 2011 study in particular concluded “that increased advertising attracts investor attention and boosts stock returns in the short run, and that managers, who are aware of this return pattern, opportunistically adjust advertising spending to inflate short-term stock prices around equity sales.”¹⁴⁶ That study suggests that retail investors, who have limited time to evaluate investment opportunities, tend to gravitate toward securities of companies that increase advertising and may “take advertising at face value and respond too optimistically,” thereby generating increases in stock price.¹⁴⁷ According to the study, the effect on stock prices is particularly significant as to consumer products companies and companies that receive little analyst attention:

Consistent with the idea that advertising for a consumer product (e.g., the iPhone) is more attention-grabbing (salient) than advertising for an industrial product (e.g., a silicon plate), the documented return effect of advertising is significantly more pronounced for firms in consumer-product industries than those in non-consumer-product industries. In addition, the return effect is also stronger for firms with lower analyst coverage than those with higher coverage (adjusted for firm size), as the former has fewer alternative information sources than the latter, thus investors (in particular, retail investors) would have to rely more on advertising for information when investing in the former.¹⁴⁸

A 2009 study similarly concludes “that the advertising effect on long-run stock returns is . . . stronger for small stocks, value stocks, and stocks that had either poor operating performance or stock performance in the prior year.”¹⁴⁹ That same study also suggests that advertising tends to increase trading and analyst coverage, thereby contemporaneously affecting stock price.¹⁵⁰

It is unclear, however, whether the effect of advertising on stock returns results from the mere fact of advertising expenditures, from the content of advertisements, or from both. One theory posits that stock price is affected because the very fact of advertising signals financial health and positive future earnings.¹⁵¹ If this theory explains the entire effect on stock prices, then whether an advertisement includes a false or misleading statement is of little consequence. Studies suggest, however, that

contemporaneous to increased advertising” and indicating that the study “suggest[s] that the . . . pattern in advertising spending around insider sales and equity offerings is most consistent with the interpretation that managers use advertising to temporarily inflate stock prices for their own benefit, as well as potentially, that of existing shareholders.”).

¹⁴⁶ Lou, *Attracting Investor Attention*, *supra* note 145, at 5-6.

¹⁴⁷ *Id.* at 1.

¹⁴⁸ *Id.* at 2.

¹⁴⁹ Chemmanur & Yan, *supra* note 145, at 5.

¹⁵⁰ *See id.* (“In particular, we find that advertising increases the levels of trading turnover and analyst coverage. The increased levels of trading turnover and analyst coverage increases [sic] contemporary stock returns but are followed by lower future stock returns.”).

¹⁵¹ Joshi & Hanssens, *supra* note 145, at 22; *see* Lou, *Attracting Investor Attention*, *supra* note 145, at 15 (“[A] signaling model argues that, while the content of advertising may be uninformative about the firm’s future profitability and growth prospects, the act of advertising can be a value-relevant signal . . .”).

content is important as well,¹⁵² and if that is so, such statements indeed may have an effect on market price.

Because empirical evidence suggests that advertising does in fact influence investment decisions and that managers know this, adopting the rule Muratori suggested—that advertisements should be deemed outside the scope of Rule 10b-5 as a matter of law—is inappropriate. As the Supreme Court noted in *Zandford*, one of the goals of Rule 10b-5 is to ensure the “integrity of the securities markets.”¹⁵³ Removing from Rule 10b-5’s scope a communication that actually affects investor decision-making and that, in some cases, is intended to do so, would conflict with this goal.

C. The Approach to “Offers” Under the Securities Act of 1933 Recognizes the Possible Effect of Advertisements on Investors

In enforcing restrictions under the Securities Act on communications related to securities offerings, the SEC long has recognized that product advertising may—but usually does not—constitute an impermissible communication. Accordingly, when it implemented reforms to the communications rules in 2005, the SEC adopted rules to facilitate advertising in the ordinary course of a company’s business. Implicit in the SEC’s approach to advertisements in the context of the Securities Act is an acknowledgement, consistent with the empirical studies discussed above, that advertising can affect investor decisions. One therefore finds further support for concluding that product advertisements can meet Rule 10b-5’s transactional nexus requirement in the treatment of such advertisements under the Securities Act.

1. The “Gun-Jumping Rules”

Section 5 of the Securities Act of 1933 (Securities Act)¹⁵⁴ provides stringent restrictions—known as “gun-jumping rules”—on how issuers may communicate with respect to an offering of securities.¹⁵⁵ Specifically, the gun-jumping rules restrict “offers,” both as to their timing and as to their form. Under section 5(c), it is unlawful “to *offer* to sell or *offer* to buy . . . any security, unless a registration statement has been filed as to such security.”¹⁵⁶ After a registration statement is filed, section 5(b)(1) makes it unlawful to use a “prospectus relating to any security with respect to which [the] registration statement [was] filed . . . , unless such prospectus meets the requirements of section 10 [of the Securities Act].”¹⁵⁷ The term

¹⁵² See Lou, *Attracting Investor Attention*, *supra* note 145, at 16 (indicating that the “signaling model” is incomplete because it does not explain why, subsequent to increased advertising, stock prices decline); Joshi & Hanssens, *supra* note 145, at 22 (“We hypothesize that [brand] equity, which is created through marketing activity and is ostensibly directed at customers and prospects, can spill over into investment behavior as well.”).

¹⁵³ *Sec. & Exch. Comm’n v. Zandford*, 535 U.S. 813, 821 (2002).

¹⁵⁴ 15 U.S.C. §§ 77a–77aa (2006).

¹⁵⁵ See *Securities Offering Reform*, 70 Fed. Reg. 44,722, 44,731 (Aug. 3, 2005) (codified at 17 C.F.R. pt. 200) (2012)) (referring to sections 5(b)(1) and 5(c) as “gun jumping provisions”).

¹⁵⁶ 15 U.S.C. § 77e(c) (2006) (emphasis added).

¹⁵⁷ 15 U.S.C. § 77e(b)(1) (2006).

“prospectus” extends to any “communication, written or by radio or television, which *offers* any security for sale.”¹⁵⁸

The term “offer” is broadly defined, making the restrictions imposed under the gun-jumping rules significant. The term includes not only formal offers,¹⁵⁹ but also any communication that conditions the market for a securities offering.¹⁶⁰ The SEC explained in *In re Carl M. Loeb, Rhoades & Co.* that a broad definition of the term “offer” is necessary to serve the purposes of section 5, one of which is to ensure that extensive information with respect to a person issuing securities is available to investors and that investors have time to consider the information.¹⁶¹ The SEC observed that:

[s]ecurities are distributed in this country by a complex and sensitive machinery geared to accomplish nationwide distribution of large quantities of securities with great speed. Multi-million dollar issues are often oversubscribed on the day the securities are made available for sale. This result is accomplished by a network of prior informal indications of

¹⁵⁸ 15 U.S.C. § 77b(a)(9) (2006) (emphasis added). The term “written” likewise is broad and includes most electronic communications, including e-mail, facsimiles, and websites. *See* 17 C.F.R. § 230.405 (2012) (defining the term “written communication” to include a “graphic communication” and defining the term “graphic communication” to include “all forms of electronic media, [except] . . . communication[s] that . . . originate[] live, in real-time to a live audience and do[] not originate in recorded form”).

¹⁵⁹ *See* *Diskin v. Lomasney & Co.*, 452 F.2d 871, 875 (2d Cir. 1971) (“The statutory language defining ‘offer’ in § 2(3) ‘goes well beyond the common law concept of any offer.’”); *Sec. & Exch. Comm’n v. Starmont*, 31 F. Supp. 264, 266 (E.D. Wash. 1940) (“The Act defines . . . ‘offer to sell,’ and ‘offer for sale,’ likewise more broadly than the lawyer or the layman previously thought or even imagined.”); *In re Carl M. Loeb, Rhoades & Co.*, Exchange Act Release No. 34-5870, 1959 WL 59531, at *4 (Feb. 9, 1959) (“It is apparent that [the term ‘offer to sell’ is] not limited to communications which constitute an offer in the common law contract sense, or which on their face purport to offer a security.”). Section 2(3) of the Securities Act defines the term “offer” to “include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.” 15 U.S.C. § 77b(a)(3) (2006).

¹⁶⁰ *See* *Loeb, Rhoades*, 1959 WL 59531, at *6 (“[T]he statute prohibits issuers, underwriters and dealers from initiating a public sales campaign prior to the filing of a registration statement by means of publicity efforts which, even though not couched in terms of an express offer, condition the public mind or arouse public interest in the particular securities.”); *Publication of Information Prior to or After the Effective Date of a Registration Statement*, Securities Act Release No. 33-3844, 1957 WL 3605, at *2 (Oct. 8, 1957) (“[T]he publication of information and statements, . . . although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest . . . in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.”); *Guidelines for Release of Information by Issuers Whose Securities are in Registration*, Securities Act Release No. 33-5180, 1971 WL 120474, at *1 (Aug. 20, 1971) (“[T]he publication of information and statements, and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer in violation of the Act.”).

¹⁶¹ *See* *Loeb, Rhoades*, 1959 WL 59531, at *5 (describing “[o]ne of the cardinal purposes of the Securities Act”). *Loeb, Rhoades* “is the seminal and still leading SEC decision” on the scope of the term “offer” under the Securities Act. HAZEN, *supra* note 11, § 2.3[2], at 83.

interest or offers to buy between underwriters and dealers and between dealers and investors based upon mutual expectations that, at the moment when sales may legally be made, many prior indications will immediately materialize as purchases. It is wholly unrealistic to assume in this context that “offers” must take any particular legal form. Legal formalities come at the end to record prior understandings, but it is the procedures by which these prior understandings, embodying investment decisions, are obtained or generated which the Securities Act was intended to reform.¹⁶²

The SEC recognized, though, that it can be difficult to determine whether the release of particular information is part of an effort to sell securities or is an unrelated disclosure.¹⁶³ According to the SEC, “[w]hether in any particular case publicity is an offer depends upon all the facts, and the surrounding circumstances including the nature, source, distribution, timing, and apparent purpose and effect of the published material.”¹⁶⁴

In *Loeb, Rhoades*, the SEC specifically addressed product advertising and stated that, when carried out in the ordinary course of business, it does not condition the market for a securities offering.¹⁶⁵ Implicit in the SEC’s statement, however, is that advertisements outside the ordinary course of business may condition the market, and in guidance issued prior to *Loeb, Rhoades*, the SEC cited as an example of a communication it considered to violate section 5 an “advertisement [that] took the conventional form of a product advertisement except for the inclusion of calculations of per-share asset values.”¹⁶⁶

At its core, the “conditioning the market” concept is just another way of identifying when a particular communication is connected to a particular securities transaction. Consequently, the fact that an advertisement may condition the market for a securities offering likewise suggests that an advertisement may meet Rule 10b-5’s “in connection with” requirement.¹⁶⁷

¹⁶² *Loeb, Rhoades*, 1959 WL 59531, at *5.

¹⁶³ *Id.* at *7.

¹⁶⁴ *Id.* at *7 n.20.

¹⁶⁵ *Id.* at *6.

¹⁶⁶ The issuer published the widely-circulated advertisement after it had filed a registration statement and sales of the securities proved difficult. Because the issuer had filed a registration statement, the advertisement was not alleged to violate Securities Act § 5(c), but Securities Act § 5(b)(1). Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities Act Release No. 33-3844, 1957 WL 3605, at *4 (Oct. 8, 1957)

¹⁶⁷ The language used by the SEC in *Loeb, Rhoades* with respect to conditioning the market and by the Second Circuit in *Texas Gulf Sulphur* with respect to the “in connection with” requirement highlights the similarity of the principles involved. For example, finding that a press release conditioned the market, the SEC in *Loeb, Rhoades* observed that the “release . . . was of a *character calculated*, by arousing and stimulating investor and dealer interest . . . , to set in motion the processes of distribution. *In fact it had such an effect.*” *Loeb, Rhoades*, 1959 WL 59531, at *6 (emphasis added). Similarly, in *Texas Gulf Sulphur*, the Second Circuit found that a representation is “in connection with” a securities transaction if it is made “in a manner reasonably *calculated* to influence the investing public” and is so calculated if it is “of a *sort* that would cause reasonable investors to rely thereon, and in

The SEC also has recognized that advertisements that do not condition the market for a securities offering nevertheless may have an effect on, or a connection to, securities transactions. Acknowledging that “the publication periodically of material business and financial facts, knowledge of which is essential to an informed trading market in such securities,” is a basic purpose of the securities laws, the SEC in 1971 attempted to provide guidance as to what types of communications generally are not considered to be conditioning the market even though a company is planning a public offering.¹⁶⁸ Although the commission declined to offer a comprehensive list of communications that do not violate Securities Act § 5, the SEC encouraged issuers intending a public offering to continue to advertise their products and services, to send out periodic reports to investors, to make press releases as to “factual business and financial development,” and to respond to inquiries regarding “factual matters from securities analysts, financial analysts, security holders, and participants in the communications filed who have a legitimate interest in corporate affairs.”¹⁶⁹

In considering the significance of advertisements among the SEC’s list of permissible communications, one must bear in mind that the gun-jumping rules restrict communications with respect to a forthcoming public offering, not communications with respect to securities that already are outstanding. In fact, the SEC in its 1971 guidance wished to encourage communications designed to inform investors in the secondary market. As the SEC had noted previously in *Loeb, Rhoades*, “[t]his flow of normal corporate news, unrelated to a selling effort for an issue of securities, is natural, desirable and entirely consistent with the objective of disclosure to the public which underlies the federal securities laws.”¹⁷⁰

The fact, then, that the SEC included product advertisements in its 1971 list is peculiar. Periodic reports, press releases, and responses to inquiries by analysts and investors clearly are designed to inform investors and are directed toward them. Advertisements, on the other hand, typically are designed to sell products and are targeted to customers. By including product advertisements among investor-focused communications, the SEC either was acknowledging the importance of such advertisements in informing the market or was responding to a concern that such advertisements might be perceived as informing the market. Regardless of its purpose, the SEC recognized that product advertisements may have a connection to securities transactions.

2. 2005 Securities Offering Reform

The SEC in its 2005 Securities Offering Reform gave further attention to the interplay between the gun-jumping rules and an issuer’s advertising efforts. Through the reform, the SEC sought to update the Securities Act’s approach to

connection therewith, so relying, cause them to purchase or sell a corporation’s securities.” Sec. & Exch. Comm’n. v. Tex. Gulf Sulphur, 401 F.2d 833, 862, 860 (2d Cir. 1968) (emphasis added).

¹⁶⁸ Guidelines for Release of Information by Issuers Whose Securities are Registration, Securities Act Release No. 33-5180, 1971 WL 120474, at *1-2 (Aug. 20, 1971).

¹⁶⁹ *Id.* at *2.

¹⁷⁰ *Loeb, Rhoades*, 1959 WL 59531, at *7.

public offerings and to provide relief from the statute's very rigid requirements.¹⁷¹ One of the primary areas of reform related to communications with respect to registered offerings, and through new regulations, the SEC intended to aid investor and market access to information.¹⁷²

In adopting the reform, the SEC observed that:

issuers engage in all types of communications on an ongoing basis, including, importantly, communications mandated or encouraged by . . . rules under the Exchange Act, rules or listing standards of national securities exchanges, and comparable requirements in foreign jurisdictions . . . [and that] [such] changes in the Exchange Act disclosure regime and the tremendous growth in communications technology are resulting in more information being provided to the market on a more non-discriminatory, current, and ongoing basis.¹⁷³

The SEC viewed these developments as positive and sought to facilitate the flow of information by relaxing the restrictions the gun-jumping rules place on “communications that would be beneficial to investors and markets.”¹⁷⁴ The reform did this in a number of ways, including the adoption of Rules 168 and 169 under the Securities Act, which give issuers greater certainty that the regular release of factual information, including product advertisements, will not be considered to be conditioning the market for—or, said another way, connected to—a public offering.¹⁷⁵

Rules 168 and 169 facilitate the flow of information by deeming certain communications not to be offers and therefore not subject to the restrictions in Securities Act §§ 5(b)(1) and 5(c).¹⁷⁶ Rule 168, which is available only to SEC reporting companies and certain foreign issuers, exempts a broader range of communications than does Rule 169, which is available to all issuers, including non-reporting companies.¹⁷⁷ Both rules, however, protect “regularly released factual

¹⁷¹ See Securities Offering Reform, 70 Fed. Reg. 44,722, 44,722 (Aug. 3, 2005) (“Today’s rules will eliminate unnecessary and outmoded restrictions on offerings.”).

¹⁷² *Id.* at 44,725.

¹⁷³ *Id.* at 44,731.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* at 44,735; 17 C.F.R. § 230.168(b)(1) (2012); 17 C.F.R. § 230.169(b)(1) (2012). The safe harbors in Rules 168 and 169 are over-inclusive, purporting to exempt from the requirements of section 5 communications that would not be considered to condition the market under prior SEC interpretations. For example, in its 1959 opinion in *Loeb, Rhoades*, the SEC indicated that a corporation may, without running afoul of section 5, continue to advertise its products in the ordinary course of its business. *Loeb, Rhoades*, 1959 WL 59531, at *7. Likewise, in its 1971 release, the SEC reiterated that product advertisements generally do not condition the market in violation of section 5. Guidelines for Release of Information by Issuers Whose Securities are Registration, Securities Act Release No. 33-5180, 1971 WL 120474, at *2 (Aug. 20, 1971). Nevertheless, the SEC adopted Rules 168 and 169, which offer a safe harbor for product advertisements.

¹⁷⁶ 17 C.F.R. § 230.168(a) (2012); 17 C.F.R. § 230.169(a) (2012).

¹⁷⁷ See 17 C.F.R. § 230.168(a) (2012) (providing that the exemption under the Rule only applies to “[a]n issuer that is required to file reports pursuant to section 13 or section 15(d) of

business information,”¹⁷⁸ and under both rules, product advertisements are considered to be factual business information.¹⁷⁹

In addition to advertisements, both rules extend to “[f]actual information about the issuer, its business or financial developments, or other aspects of its business,” including, for reporting companies, information included in periodic reports to the SEC.¹⁸⁰ Just as it did in its 1971 guidance, then, the SEC in Rules 168 and 169 included advertisements with information specifically directed to investors, perhaps suggesting once again that advertisements may inform the market and therefore have a connection to securities transactions.

V. DETERMINING WHEN AN ADVERTISEMENT MEETS THE “IN CONNECTION WITH” REQUIREMENT

As discussed above, the causation and intent-based approaches to the “in connection with” requirement as it relates to publicly disseminated information leave the door open for finding that false or misleading statements in product advertisements are subject to Rule 10b-5. Moreover, recent empirical studies, the SEC’s historical treatment of advertisements for purposes of the gun-jumping rules, and the treatment of advertisements in the 2005 Securities Offering Reform indicate that advertisements may, and probably do, have an impact on investor decision-making. If that is the case, the question then becomes how a court decides when a particular statement included in an advertisement meets the “in connection with” requirement.

A. Public Companies and the Causation-Based Approach

In *Carter-Wallace*, the Second Circuit concluded that it could not find as a matter of law that allegedly false statements in pharmaceutical advertisements published in technical journals were not “in connection with” transactions in the pharmaceutical company’s securities on the secondary market.¹⁸¹ To the contrary, the court held that such advertisements satisfy Rule 10b-5’s transactional nexus requirement if a plaintiff can prove that market professionals used the advertisements in analyzing the company’s securities.¹⁸² In so doing, the court rejected the 1978 decision of the United States District Court for the Southern District of New York in *Ross* that such advertisements do not have the appropriate nexus.¹⁸³

the Securities Exchange Act of 1934” and certain foreign companies and exempting “regularly released factual business information and forward-looking information”); 17 C.F.R. § 230.169(a) (2012) (exempting only “regularly released factual business information”). Although technically available to them, reporting companies have no reason to use Rule 169 because all of the information subject to exemption under Rule 169 is subject to exemption under Rule 168 and the conditions for exemption under Rule 168 are less onerous than those under Rule 169. Compare 17 C.F.R. § 230.168(b)(1), (d) (2012), with 17 C.F.R. § 230.169(b)(1), (d) (2012).

¹⁷⁸ 17 C.F.R. § 230.168(a) (2012); 17 C.F.R. § 230.169(a) (2012).

¹⁷⁹ 17 C.F.R. § 230.168(b)(1)(ii) (2012); 17 C.F.R. § 230.169(b)(1)(ii) (2012).

¹⁸⁰ 17 C.F.R. § 230.168(b)(1)(i) (2012); 17 C.F.R. § 230.169(b)(1)(i) (2012).

¹⁸¹ *Carter-Wallace, Inc. v. Hoyt*, 150 F.3d 153, 156 (2d Cir. 1998).

¹⁸² *Id.* at 156-57.

¹⁸³ *Id.* at 156.

The Second Circuit distinguished *Ross* because it was decided before the Supreme Court in *Basic* had recognized the relevance of the “fraud-on-the-market” theory to the element of reliance in a private cause of action under Rule 10b-5.¹⁸⁴ In light of the fact that the key to the test adopted by many courts with respect to publicly disseminated information is whether the information is of a type on which reasonable investors would rely, the court’s conclusion in *Carter-Wallace* makes perfect sense. Acknowledging the efficacy of a presumption of reliance, the Supreme Court in *Basic* observed that “[r]ecent empirical studies [had] tended to confirm . . . that the market price of shares traded on a well-developed market reflects all publicly available information, and, hence any material misrepresentations.”¹⁸⁵ Consistent with this premise, *Carter-Wallace* noted that the ability of the market to “absorb technical medical information is neither novel nor surprising.”¹⁸⁶ It seems even more likely that the market could—and based on recent empirical studies, it appears the market does—incorporate the less technical and more readily available information in ordinary product advertisements such as those for Apple’s iPad.

Since *Carter-Wallace* was decided in 1998, due to technological advances, a wide array of information has become more readily available. The SEC recognized this fact when it adopted the 2005 Securities Offering Reform and noted that

[c]omputers, sophisticated financial software, electronic mail, teleconferencing, videoconferencing, webcasting, and other technologies available today have replaced, to a large extent, paper, pencils, typewriters, adding machines, carbon paper, paper mail, travel, and face-to-face meetings relied on previously. The rules we are adopting today seek to recognize the integral role that technology plays in timely informing the markets and investors about important corporate information and developments.¹⁸⁷

The most significant changes under the reform with respect to the gun-jumping rules’ limitations on communications benefit large issuers known as “well-known seasoned issuers” or “WKSIs.”¹⁸⁸ WKSIs are almost completely exempt from the gun-jumping rules.¹⁸⁹

¹⁸⁴ See *id.* at 156 (“*Ross* pre-dated *Basic* . . . and considered only the nexus between advertisements and individual investments; it did not consider the “fraud-on-the-market” theory . . .”).

¹⁸⁵ *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988).

¹⁸⁶ *Carter-Wallace*, 150 F.3d at 153.

¹⁸⁷ Securities Offering Reform, 70 Fed. Reg. 44,722, 44,726 (Aug. 3, 2005).

¹⁸⁸ *Id.* at 44,727. A WKSI is a public company whose outstanding common equity held by non-affiliates has a “worldwide market value” of at least \$700 million or who in the prior three years has made registered offerings for cash of at least \$1 billion of non-convertible securities. See 17 C.F.R. § 230.405 (2012) (defining the term “well-known seasoned issuer”).

¹⁸⁹ The SEC did this in two ways primarily. First, it introduced the “automatic shelf registration statement” concept. Securities Offering Reform, 70 Fed. Reg. at 44,777; see 17 C.F.R. § 230.405 (2012) (defining the term “automatic shelf registration statement”). A WKSI may file an automatic shelf registration statement to register “unspecified amounts of different types of specified securities.” Securities Offering Reform, 70 Fed. Reg. at 44,777;

In relaxing the gun-jumping rules with respect to WKSIs, the SEC relied on the fact that “[t]oday, the largest issuers are followed by sophisticated institutional and retail investors, members of the financial press, and numerous sell-side and buy-side analysts that actively seek new information on a continual basis.”¹⁹⁰ Given the attention the market gives to WKSIs, it seems very likely that the market price of their securities incorporates material information included in their product advertisements. Moreover, the empirical studies described above suggest that, not only are the stock prices for securities of large issuers affected by advertising, but those of small issuers are as well and that the market price effect for securities of small issuers tends to be more pronounced.¹⁹¹ Therefore, it seems almost a foregone conclusion that statements made by public companies in their product advertisements would meet a causation-based test for Rule 10b-5’s transactional nexus requirement.

B. Factors from the Approach to “Offers” Under the Securities Act of 1933

Given that a determination of whether a particular communication conditions the market for a securities offering is, in essence, a determination of whether the communication is connected to the offering, the SEC’s historical guidance as to when a communication conditions the market and the conditions under which the safe harbor in Rule 169¹⁹² is available are useful tools for determining whether a

see 17 C.F.R. § 230.430B (2012) (“[A] form of prospectus filed as part of an automatic shelf registration statement for offerings pursuant to Rule 415(a) . . . , other than Rule 415(a)(vii) or (viii), also may omit information as to . . . a description of the securities other than an identification of the name or class of such securities.”); 17 C.F.R. § 230.457(r) (2012) (indicating that an automatic shelf registration statement “does not need to include the number of shares or units of securities or the maximum aggregate offering price of any securities until the issuer” updates the table in the registration statement calculating the registration fee). The issuer also may add securities to the registration statement after it becomes effective. Securities Offering Reform, 70 Fed. Reg. at 44,779; *see* 17 C.F.R. § 230.413(b)(1) (2012) (allowing amendment of automatic shelf registration statements to add new classes of securities). By filing automatic shelf registration statements, then, WKSIs can eliminate as to a wide range of securities the restrictions against offers in section 5(c), because section 5(c) only applies pre-filing. Second, the 2005 reform added Rule 163, which exempts WKSIs from the prohibition against offers in section 5(c) as to securities for which no registration statement has been filed, so long as the WKSI meets the conditions of the rule. *See* Securities Offering Reform, 70 Fed. Reg. at 44,741 (noting that Rule 163 allows WKSIs “to engage in unrestricted oral and written offers before a registration statement is filed”); 17 C.F.R. § 230.163(a) (2012) (providing that communications complying with the rule are exempt from the prohibition against offers under Exchange Act § 5(c)).

¹⁹⁰ Securities Offering Reform, 70 Fed. Reg. at 44,727.

¹⁹¹ *See* Lou, Attracting Investor Attention, *supra* note 145, at 2 (noting the effect of advertising on the market price of securities for companies that are not followed closely by analysts).

¹⁹² Rule 168 also provides conditions that can be useful as factors, but the same conditions apply in Rule 169. *Compare* 17 C.F.R. § 230.168(d)(1), (2) (2012), *with* 17 C.F.R. § 230.169(d)(1), (2) (2012). Rule 169, however, includes an additional condition that is relevant to the “in connection with” requirement. *See* 17 C.F.R. § 230.169(d)(3) (2012) (imposing a condition not included in Rule 168).

false or misleading statement in an advertisement meets Rule 10b-5's "in connection with" requirement.¹⁹³

In *Loeb, Rhoades*, the SEC stated that whether particular publicity is connected with the selling effort for a public offering depends on the facts and circumstances of the publicity and, in evaluating whether such a connection exists, consideration should be given to "the nature, source, distribution, timing, and apparent purpose and effect of the published material."¹⁹⁴ Rule 169, because it is a safe harbor, offers more concrete considerations. Under Rule 169, a product advertisement will be deemed not to be an offer (and therefore not subject to the restrictions in Securities Act § 5) if it is "regularly released or disseminated" and:

- (1) The issuer has previously released or disseminated information of the type described in this section in the ordinary course of its business;
- (2) The timing, manner, and form in which the information is released or disseminated is consistent in material respects with similar past releases or disseminations; [and]
- (3) The information is released or disseminated for intended use by persons, such as customers and suppliers, other than in their capacities as investors or potential investors in the issuer's securities, by the issuer's employees or agents who historically have provided such information¹⁹⁵

The considerations and conditions described above can provide valuable insight both as to whether there is a causal link between a false or misleading advertisement and a securities transaction and as to whether a defendant intended an advertisement to, or knew or was reckless in not knowing that the advertisement could, influence an investment decision. If an advertisement deviates from a company's ordinary practice, it may be more likely that an investor would take note of it and rely on it. Likewise, such a deviation may indicate that the company intended to influence the market. Therefore, the considerations and conditions could prove useful to a court applying the "in connection with" requirement regardless of whether the court takes a pure causation-based approach or it adds—as the Third and Tenth Circuit may—an intent-based component.

CONCLUSION

In 1998, the Second Circuit in *Carter-Wallace* opened the door to securities fraud claims based on false or misleading statements in marketing materials. When it was decided, *Carter-Wallace* was consistent with the Second Circuit's general approach to Rule 10b-5's transactional nexus requirement with respect to publicly disseminated statements. It is consistent today with similar approaches adopted by

¹⁹³ See Benjamin Shook, *The Materiality Standard After Matrixx Initiatives, Inc. v. Siracusano*, 12 N.C. J. L. & TECH. 369, 383 (Spring 2011) (suggesting that "[t]he SEC may view normal advertising in the Rule 10b-5 context in the same way as it does in the context of public offerings").

¹⁹⁴ *In re Carl M. Loeb, Rhoades & Co., Exchange Act Release No. 34-5870*, 1959 WL 59531, at *7 n.20 (Feb. 9, 1959).

¹⁹⁵ 17 C.F.R. § 230.169(d) (2012). Qualification for the safe harbor also is conditioned on the issuer's not being an investment company under the Investment Company Act. 17 C.F.R. § 230.169(d)(4) (2012). That condition, however, is irrelevant to Rule 10b-5's "in connection with" requirement.

other circuits. In addition, the SEC for more than fifty years has acknowledged that product advertisements may communicate information to investors, and recent empirical studies suggest that product advertisements indeed do so and that managers know it. Therefore, even if it did at one time, Rule 10b-5's "in connection with" requirement no longer stands as a substantial barrier to application of the Rule to false or misleading product advertising. As a result, Apple and other companies should think hard before using marketing materials with bold and unqualified representations about their products' capabilities.