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## *Second Circuit Provides Guidance on the Nature of Disclosures That Will Avoid Liability for Market Manipulation*

BY THE SECURITIES LITIGATION AND ENFORCEMENT PRACTICE

Private securities fraud claims brought under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 are most commonly premised on alleged misstatements or omissions in information provided to investors about a publicly-traded company. However, Section 10(b) and Rule 10b-5 encompass a broader range of fraudulent activity, including "manipulative" market conduct.

In *Wilson v. Merrill Lynch & Co., Inc.*, \_\_\_\_ F.3d \_\_\_, 2011 WL 5515958 (2d Cir. Nov. 14, 2011), the Second Circuit examined an investor's class action complaint alleging "manipulative" market conduct arising from the widespread disruption of the auction rate securities markets in February 2008. Echoing claims asserted separately against virtually all of the major financial institutions that participated in the auction rate securities markets, the plaintiff claimed that Merrill Lynch & Co., Inc. ("Merrill") manipulated auctions for which it served as a dealer through its practice of placing "support bids" for the securities. In a unanimous opinion, the Second Circuit upheld dismissal of the case on a motion to dismiss, finding that where the conduct alleged to be manipulative is "fairly" disclosed to the market, a plaintiff is precluded from pleading the "manipulative acts" element of a market manipulation claim.

### **Background of the Case**

Auction rate securities ("ARS") are long-term variable rate instruments (bonds or preferred stock) issued by public or private entities, with interest rates or dividends to be set periodically on a short-term basis through public Dutch auctions of the issued securities.

Auctions for ARS are typically conducted under the auspices of one or more financial institutions, such as Merrill. These financial institutions are permitted to bid in the auctions for their own account and often did so, at least until the credit crisis reached a crescendo in late 2007-early 2008.

Merrill, as had other financial institutions, publicly disclosed that it "may routinely place one or more bids in an auction for its own account to acquire auction rate securities for its inventory, to prevent an auction failure . . . or an auction from clearing at a rate that Merrill believes does not reflect the market for the securities." Merrill also warned that "[i]nvestors should not assume that Merrill Lynch will do so or that auction failures will not occur." After these disclosures were posted on Merrill's website, the plaintiff, Colin Wilson, purchased from E\*Trade certain ARS for which Merrill served as an auction broker.

Following the disruption of the ARS markets in February 2008, Wilson claimed that the auction failures resulted in him being unable to liquidate his ARS investments. A putative class action lawsuit was filed against Merrill alleging, *inter alia*, that Merrill violated Section 10(b) and Rule 10b-5 by manipulating ARS markets through its practice of support bidding. The district court granted Merrill's motion to dismiss after concluding that Merrill's disclosures precluded a finding that Merrill engaged in "manipulative" actions. On appeal, Wilson argued that Merrill's disclosures were incomplete or misleading.

### **The *Wilson* Decision**

The Supreme Court describes market manipulation as "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 198 (1976). The Second Circuit has articulated the elements of a private civil claim of market manipulation under Section 10(b) and Rule 10b-5 as:

- (1) manipulative acts; (2) damage (3) caused by reliance on an assumption of an efficient market free of manipulation; (4) scienter; (5) in connection with the purchase or sale of securities; (6) furthered by the defendant's use of the mails or any facility of a national securities exchange.

*ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 101 (2d Cir. 2007).

Against this background, the *Wilson* court summarized its view of the existing law by stating that "[t]he gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators." *Wilson*, 2011 WL 5515958, at \*7 (quoting *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999)). Thus, the court reasoned, "[i]n order for market activity to be manipulative, that conduct must involve misrepresentation or nondisclosure," because "the market is not misled when a transaction's terms are fully disclosed." *Id.* at \*8 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977)).

The determinative issue in *Wilson* concerned what a plaintiff must plead in order to state a market manipulation claim in the face of public disclosures that explained that Merrill "may routinely" engage in the very conduct alleged to be manipulative in violation of Section 10(b) and Rule 10b-5. In considering this question, the court looked to another recent Second Circuit case based on alleged misrepresentations concerning ARS, *Ashland Inc. v. Morgan Stanley & Co., Inc.*, 652 F.3d 333 (2d Cir. 2011). In *Ashland*, the court found that sophisticated ARS investors could not "plead reasonable reliance on Morgan Stanley's alleged misrepresentations [that ARS were 'safe, liquid investments'] in light of Morgan Stanley's publicly-filed statement explicitly disclosing the very liquidity risks about which [the investors] claim to have been misled." *Id.* at 335. In particular, the court looked to the disclosures made by Morgan Stanley in which – like Merrill– Morgan Stanley disclosed that it routinely bid in auctions for its own account, but did so at its own discretion and "[w]as not obligated to bid in any auction to prevent an auction from failing." *Id.* at 336 & 338.

Turning to how these disclosures might affect a claim of market manipulation, the *Wilson* court observed that "there can be no dispute that the general phenomenon of ARS dealers placing bids to prevent failed auctions . . . was publicly disclosed by the time that Wilson purchased his ARS in July 2007." *Wilson*, 2011 WL 5515958, at \*9. Moreover, the court found that Merrill's own "disclosures revealed, at the very least, the possibility that Merrill would place support bids in some auctions that it managed and that in the absence of these bids, some of these auctions might fail." *Id.* at \*10. The

court also observed that “Wilson’s manipulation claim also appears to rest on his allegation that Merrill failed to disclose its true purposes for intervening in the auctions . . . aver[ring] that Merrill placed bids in its auctions not to reflect the market for the ARS but rather to create a false impression of demand, to sustain the market as long as possible.” *Id.* at \*12.

Notably, unlike in *Ashland*, the *Wilson* court analyzed the efficacy of the plaintiff’s allegations in the context of whether he adequately alleged the manipulative acts element of his claim. The court explained that “[o]ur assessment of whether Wilson has pleaded a ‘manipulative act’ does not turn on how Wilson may have interpreted Merrill’s disclosures; indeed, Wilson does not claim that he directly relied on any statement attributable to Merrill. Rather, in analyzing this claim, we look to whether Merrill’s support bidding sent a false signal to the Merrill ARS market as a whole.” *Id.* at \*13.

Thus, in deciding that Wilson’s complaint failed to allege facts sufficient to sustain a reasonable inference of manipulative acts, the court found that even if Merrill, at least for a time, placed support bids in every single auction for its ARS, “we do not see how that allegation can be actionable given Merrill’s disclosure that it ‘may routinely’ place such bids” because that statement “is not inconsistent with the possibility that it would place such bids in every Merrill ARS auction that took place over a particular period.” *Id.* at \*11. “If Merrill’s intention was, as Wilson alleges, to place support bids in every single auction unless it decided to let certain auctions fail or withdraw from the market altogether, we think Merrill fairly disclosed that intention by stating that it ‘may routinely’ place such bids.” *Id.*

Finally, the court found that the nature of Merrill’s disclosures rendered Wilson’s allegations concerning the purposes behind Merrill’s support bids to be irrelevant to the inquiry. The court explained that, “[g]iven Merrill’s statements that it believed itself to be at liberty to engage in this market activity and its discussion of the possible consequences of this activity on the price and liquidity of ARS, its alleged motivation for placing support bids and its internal assessment of the ARS market do not render the disclosed practices manipulative.” *Id.* at \*12.

In summary, the court’s decision was very fact-oriented, ultimately holding that the factual allegations of Wilson’s complaint could not state a claim in the face of Merrill’s disclosures. The court asserted that its conclusion reflected “only that Merrill’s particular disclosures sufficiently alerted investors in Merrill ARS of the likelihood that the interest rates and apparent liquidity of these ARS reflected Merrill’s own interventions in these auctions rather than the ‘natural interplay of supply and demand.’” *Id.* at \*16.

## Conclusion

The *Wilson* case stands for the proposition that, in order to plead the “manipulative acts” element of a market manipulation claim under Section 10(b) and Rule 10b-5, a plaintiff must plead facts sufficient to establish that disclosures of a defendant’s market activity were materially false or misleading. As reflected by the decision in *Wilson*, that burden can be met only if the plaintiff’s factual allegations satisfy the high pleading standards established under the Private Securities Litigation Reform Act of 1995 and the Supreme Court’s decision in *Ashcroft v. Iqbal*, 566 U.S. 662 (2009). Ultimately, *Wilson*, along with the companion decision in *Ashland*, underscore the significance and value of informative, carefully crafted disclosures concerning market activity of broker-dealers and other significant participants in the securities markets.



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