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ESSAY

The SEC, Administrative Usurpation, and Insider Trading

A.C. Pritchard*

The history of insider trading law is a tale of administrative usurpation and legislative acquiescence. Congress has never enacted a prohibition against insider trading, much less defined it. Instead, the SEC has led in defining insider trading, albeit without the formality of rulemaking, and subject to varying degrees of oversight by the courts. The reason why lies in the deference that the Supreme Court gave to the SEC in its formative years.

The roots of insider trading law are commonly traced to the SEC's decision in *Cady, Roberts & Co.*¹ *Cady, Roberts* was only made possible, however, by the Supreme Court's decisions in *SEC v. Chenery Corp.*, its first brush with insider trading under the federal securities laws. In *Chenery I*, Justice Felix Frankfurter, writing for a slim majority, rebuffed the SEC's attempt to impose a crude insider trading ban in a reorganization proceeding of public utility holding company.² The alleged insider traders in *Chenery I* were managers of a holding company who had acquired preferred stock during the course of the reorganization.³ As Justice Frankfurter characterized the SEC's rule of decision, the managers "were fiduciaries and hence under a 'duty of fair dealing' not to trade in the securities of the corporation while plans for its reorganization were before the Commission."⁴ The SEC rejected a plan put forward by the company that called for the managers' preferred stock to be converted into common stock.⁵

The SEC's invocation of "fiduciary" responsibility provoked a now well-known lecture from Frankfurter on legal reasoning:

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1. 40 S.E.C. 907 (1961).

2. *SEC v. Chenery Corp.* (*Chenery I*), 318 U.S. 80, 89-90 (1943).

3. *Id.* at 81-82.

4. *Id.* at 85.

5. *Id.*

[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge those obligations? And what are the consequences of his deviation from duty?⁶

The SEC had not answered these questions. The agency had not found that the insiders “acted covertly or traded on inside knowledge” but nevertheless concluded that they had violated “broad equitable principles” recognized in earlier judicial decisions.⁷ The SEC’s reliance on precedent meant that it could also be constrained by those decisions. The SEC would not necessarily be bound by judicial precedents, Frankfurter conceded, had the agency promulgated new rules.⁸ But having “professed to decide the case before it according to settled judicial doctrines, its action must be judged by [those] standards”⁹

Justice Frankfurter suggested a willingness to defer to the SEC’s “experience and insight” but hinted that deference would require the SEC “promulgate[] a general rule.”¹⁰ This divided Frankfurter from his more liberal colleagues, Justices Hugo Black, Frank Murphy, and Stanley Reed, who rejected “[t]he intimation . . . that the Commission can act only through general formulae rigidly adhered to.”¹¹ They argued that the SEC enjoyed “wide powers to evolve policy standards, and this may well be done case by case”¹²

On remand, the SEC responded by reaching the same result while substituting a different rationale. When *Chenery* returned to the Court, Frankfurter complained to Black:

6. *Id.* at 85-86.

7. *Id.* at 86-87.

8. *Id.* at 89 (“Congress certainly did not mean to preclude the formulation by the Commission of standards expressing a more sensitive regard for what is right and what is wrong than those prevalent at the time the Public Utility Holding Company Act of 1935 became law.”).

9. *Id.*

10. *Id.* at 92. Chief Justice Stone suggested a more explicit endorsement of rulemaking. Handwritten Note from Chief Justice Harlan Fiske Stone to Justice Felix Frankfurter (undated) (on file with the Felix Frankfurter Collection, Harvard Law School Library). Frankfurter demurred:

I agree with you that had the SEC summarized their experience by putting the specific ruling in the *Chenery* case into a generalized rule, a totally different situation would have been created. But I thought it wiser to indicate that by innuendo rather than explicitly. To do the latter might be read by the Commission as a broad hint from us to issue a regulation. Thereby we would be stimulating new problems.

Letter from Justice Felix Frankfurter to Chief Justice Harlan Fiske Stone (Jan. 23, 1943) (on file with the Felix Frankfurter Collection, Harvard Law School Library).

11. *Chenery I*, 318 U.S. at 99 (Black, J., dissenting).

12. *Id.* at 100.

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[T]he Commission has decided this case *ad hoc* without any reference to considerations that would govern it in the same case tomorrow. . . . The SEC is not a Kadi sitting under a tree, dispensing judgment in each case, unrelated to general considerations.¹³

Unmoved by Frankfurter's charge of lawlessness, Murphy, Black, and Reed were now joined by new Justices Wiley Rutledge and Harold Burton to uphold the SEC's action. The *Chenery II* majority explicitly rejected Frankfurter's suggestion that the agency should proceed by rulemaking: "[T]he choice made between proceeding by general rule or by individual, *ad hoc* litigation is one that lies primarily in the informed discretion of the administrative agency."¹⁴

A generation later, a newly activist SEC, under the leadership of Chairman William Cary, exploited the policymaking freedom afforded by *Chenery II* when it launched its modern campaign against insider trading under Rule 10b-5 in *Cady, Roberts*.¹⁵ The Commission had adopted Rule 10b-5 under its Section 10(b) authority as a general antifraud prohibition, but neither the rule nor the statute mentions insider trading.¹⁶ Notwithstanding these omissions, the SEC found in *Cady, Roberts* that a partner in a brokerage firm had violated Rule 10b-5 when he shared non-public information with his firm, which traded on the information. Cary set out a broad prohibition of insider trading:

[T]he obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.¹⁷

These elements are conspicuously absent from the text of Rule 10b-5 and Section 10(b). Moreover, Congress did not anticipate such a prohibition when it adopted Section 10(b). Congress was well aware of the problem of insider trading in 1934, a topic highlighted at length by Ferdinand Pecora in the legislative hearings that led to the passage of the Securities Exchange Act.¹⁸ But Congress addressed the issue, albeit in a somewhat mechanical way, in Section 16 of the Act.¹⁹

13. Letter from Justice Felix Frankfurter to Justice Hugo Black (Dec. 23, 1946) (on file with the Robert Jackson Collection, Library of Congress).

14. *SEC v. Chenery Corp.* (*Chenery II*), 332 U.S. 194, 203 (1947).

15. *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

16. *See* Securities Exchange Act of 1934 § 10(b), ch. 404, 48 Stat. 891 (codified as amended at 15 U.S.C. § 78j(b) (2015)); 17 C.F.R. 240.10b-5 (2015).

17. *Cady, Roberts*, 40 S.E.C. at 912 (footnote omitted).

18. *See* JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 77-78* (3d ed. 2003).

19. Securities Exchange Act of 1934 § 16, ch. 404, 48 Stat. 896 (codified as amended at 15 U.S.C. § 78p (2015)).

Undeterred by the lack of textual support, Cary proclaimed that the “elements [of § 10(b)] under the broad language of the anti-fraud provisions . . . are not to be circumscribed by fine distinctions and rigid classifications.”²⁰ The SEC would interpret the securities laws as needed to root out information asymmetries in the secondary markets to protect “the buying public . . . from the misuse of special information.”²¹ Statutory literalism would not be an impediment.

Soon thereafter, the Supreme Court would endorse Cary’s free-ranging interpretive approach in *SEC v. Capital Gains Research Bureau, Inc.*²² *Capital Gains*, although turning on an interpretation of the Investment Advisers Act of 1940,²³ also gave the green light to the SEC to push the boundaries of its power generally by validating an open-ended notion of fiduciary duty: “Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation ‘enacted for the purpose of avoiding frauds,’ not technically and restrictively, but flexibly to effectuate its remedial purposes.”²⁴ Moreover, *Capital Gains* suggested that the SEC could expand its power through agency and judicial interpretation of existing statutes and regulations without cumbersome rulemaking or, still more burdensome, seeking legislation.²⁵

After the validation of its interpretive approach in *Capital Gains*, the SEC turned to the courts to pursue its campaign against insider trading. Four years later, in *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit validated the SEC’s expansive reading of Rule 10b-5.²⁶

The stakes had escalated when the Supreme Court reentered the fray in *Chiarella v. United States*,²⁷ a criminal case. But by that time the Court’s makeup had changed from the heady days of *Capital Gains*, most notably with the addition of Justice Lewis F. Powell, Jr., who would write the restrictive decisions in both *Chiarella* and *Dirks v. SEC*.²⁸ In *Chiarella*, Powell construed *Cady, Roberts* and *Texas Gulf Sulphur* narrowly to fit into his common law framework.²⁹ Powell made an uneasy peace with *Capital Gains*, adopting its equitable notions of fraud, but imposing a technical and restrictive approach to interpretation

20. *Cady, Roberts*, 40 S.E.C. at 912.

21. *Id.* at 913.

22. 375 U.S. 180 (1963).

23. 54 Stat. 847 (codified as amended at 15 U.S.C. § 80b-1 (2015)).

24. *Capital Gains*, 375 U.S. at 195 (quoting 3 SUTHERLAND, STATUTORY CONSTRUCTION 382 (3d ed. 1943)).

25. *Id.* at 199.

26. 401 F.2d 833, 847-48 (2d Cir. 1968) (en banc).

27. 445 U.S. 222, 224 (1980).

28. 463 U.S. 646, 648 (1983).

29. See A.C. Pritchard, *United States v. O’Hagan: Agency Law and Justice Powell’s Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 18-19 (1998).

rejected by that case. The result was a more limited insider trading prohibition than the government would have liked. Conspicuously, Powell made no effort to cabin *Chenery II*; despite the criminal context, he did not suggest that the lack of a statutory basis or rulemaking was an impediment to creating an insider trading prohibition.³⁰

The narrow construction of tipping liability in *Dirks* followed from the principles Powell set down in *Chiarella*. The deception required by Rule 10b-5 arose from traditional standards of fiduciary duty, focused closely on self-dealing: “whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.”³¹ But as in *Chiarella*, Powell did not call for legislation or rulemaking, thereby making the Court further complicit in the SEC’s development of an insider trading prohibition under Rule 10b-5.

In *United States v. Salman*, the Court will once again build on the common law of insider trading.³² *Salman* is an easy case on the merits. The inference that a tipper receives an indirect personal benefit when he passes information to his brother, or (indirectly) his brother-in-law, as occurred in *Salman*, is a natural one. Maher Kara thought of himself as his brother’s keeper; caring for him was a benefit to Maher, as it would be for anyone in a loving family relationship.³³ But if the result in *Salman* is easy, the opinion will be a challenging one to write if the Court wants to clarify the law of insider trading.

The Court has brought this drafting difficulty on itself, having denied certiorari in the case that actually raised the critical issue: *United States v. Newman*.³⁴ In *Newman*, the Second Circuit overturned the convictions of two hedge fund managers who received material nonpublic information via an extended tipping chain. *Newman* adopted a narrow definition of the “personal benefit” required by *Dirks* to establish a breach of duty by the tipper. An acquaintance between a tipper and tippee was not enough: there had to be “proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”³⁵ The Government’s petition for certiorari in *Newman* argued that the Second Circuit’s holding “cannot be reconciled with

30. He did suggest in private correspondence that legislation would be appropriate. See A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 934 (2003).

31. *Dirks*, 463 U.S. at 662.

32. 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016).

33. *See id.* at 1092.

34. 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015). *Newman* had its own limitations as a vehicle for Supreme Court review; the convictions in that case also foundered on the defendants’ lack of knowledge of the personal benefit provided to the tippees by their initial tippees. *Id.* at 454-55.

35. *Id.* at 452.

Dirks, which did not require an ‘exchange’ to find liability for a gift of inside information and did not impose amorphous standards for the relationships that can support liability.”³⁶

The Government overreads *Newman*, divorcing it from its facts. The relationships between the tippers and their initial tippees in *Newman* fell far short of the familial relationship in *Salman*. More to the point, the Government is clearly overstating the holding of *Dirks*. *Dirks* did not spell out the “standards for the relationship that can support liability” for insider trading. Laying down such standards was not necessary to decide the case: *Dirks* had no relationship with Secrist, his insider source. Rather, the cautious Powell left the details of the required relationship for future cases. *Newman* addressed that issue in a case that called for its resolution. *Salman* does not. If the Court feels it should decide only the case before it (a possibility, if the Court remains shorthanded without a replacement for the late Justice Antonin Scalia), the contours of insider trading doctrine will remain murky after *Salman*. *Salman* will go to jail, but little else will be resolved.

In prior cases, however, the Court has not been satisfied to simply decide the case before it. The Court’s best-known trilogy in the area—*Chiarella*, *Dirks*, and *United States v. O’Hagan*³⁷—ranged widely in defining the law of insider trading. In *Chiarella* and *Dirks*, Powell reframed the Rule 10b-5 insider trading prohibition around his preferred common law architecture, attempting to constrain overreaching by the SEC and DOJ.³⁸ After Powell’s departure, Justice Ruth Bader Ginsburg’s *O’Hagan* opinion exploited the openings in Powell’s edifice to expand the insider trading prohibition.³⁹ (A common law approach does allow room to maneuver if the Court is bent on expansion.) So *Salman* could say something meaningful—either narrow or broad—if the Court decides to assert itself. If the Court decides to tackle the personal benefit issue head on, what should it do?

The appeal of the Government’s basic argument—that there should be no qualifier on “gift” or “friend”—is that it offers a bright-line test. If you give someone valuable information knowing they might trade on it, at a minimum you have breached a duty of confidentiality. And since no one gives something for nothing, the jury should presume there was a reciprocal benefit to the tipper.⁴⁰ This version of the personal benefit test would be easy for a jury to

36. Petition for a Writ of Certiorari at 14, *Newman*, 136 S. Ct. 242 (No. 15-137) (quoting *Newman*, 773 F.3d at 452).

37. 521 U.S. 642 (1997).

38. See Pritchard, *supra* note 30, at 936-42.

39. See 521 U.S. at 642.

40. The Seventh Circuit has come close to presuming the intention to make a gift from the fact of disclosure. See *SEC v. Maio*, 51 F.3d 623, 633 (7th Cir. 1995) (“Absent some legitimate reason for Ferrero’s disclosure . . . the inference that Ferrero’s disclosure was

apply.⁴¹ If the Court were to accept this argument, however, it would amount to a sub silentio overruling of *Dirks*, which distinguished careless from self-serving breaches. Notwithstanding the novelty of the argument, there surely would be a few justices who would vote to close another “loophole” in the law of insider trading, as the Court did in *O’Hagan*.

Justice Powell, the architect of *Chiarella* and *Dirks*, would be less apt to see the space as a loophole.⁴² Although he recognized he was making common law, his approach was conservative. He was not pushing the boundaries of the common law with his insider trading opinions, although he was far from adhering religiously to established doctrine. Instead, he viewed his approach as consistent with the established practices of ethical businessmen.⁴³

The main drawback of the government’s version of the personal benefit test is that it would stress the scienter element of Rule 10b-5 by requiring juries to make challenging determinations of fraudulent intent. In *Dirks*, Powell developed the personal benefit standard—which goes to the question of duty—to cabin insider trading to actual cases of fraud; self-enrichment is a prototypical badge of fraud.

In devising the personal benefit standard, Powell also sought to protect the distribution of information to the analyst community.⁴⁴ Presuming a gift from the fact of disclosure would effectively undo *Dirks* and the space that Powell sought to preserve for analysts. The SEC has gone a considerable distance toward this result already with its enactment of Regulation FD, which prohibits selective disclosure by public companies.⁴⁵ What the SEC has not done, however, is adopt a rule making such disclosures (or their receipt) fraudulent,⁴⁶ which would expose violators to criminal enforcement. Bringing the weight of criminal law to the fight against selective disclosure appears to be the DOJ’s goal in its recent crackdown on insider trading involving expert networks. Indeed,

an improper gift of confidential corporate information is unassailable. After all, he did not have to make any disclosure, so why tell Maio anything?”).

41. More importantly from the government’s perspective, this test would give the widest possible scope to the insider trading ban under Rule 10b-5. Of course, there is another, equally clear bright-line test that could apply: the requirement of an explicit quid pro quo for the disclosure of the information. One assumes that the government would be less pleased with that rule, despite its clarity.

42. Cf. Pritchard, *supra* note 29, at 32-34 (showing Powell’s rejection of the misappropriation theory as inconsistent with *Chiarella* and *Dirks*).

43. See Pritchard, *supra* note 30 at 936 & n.585.

44. A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 860-61 (2015).

45. 17 C.F.R. §§ 243.100-103 (2015).

46. *Id.* at § 243.102 (“No failure to make a public disclosure required solely by [Regulation FD] shall be deemed to be violation of Rule 10b-5 . . .”).

the government pointed to Reg. FD as supporting the convictions in *Newman*.⁴⁷ Presuming selective disclosures are fraudulent would aggressively expand Rule 10b-5's common law prohibition.

The criminal implications of a broader interpretation might give pause to even the most enthusiastic proponents of market integrity. Some of the Justices may worry that the government is criminalizing previously accepted market behavior through a novel interpretation of Rule 10b-5 rather than seeking legislation, or at least rulemaking. The theme of Salman's brief in the Supreme Court is that due process concerns regarding fair notice, bolstered by a dash of separation of powers, counsel in favor of the Court's adopting a narrow quid pro quo standard for personal benefit.⁴⁸

Salman's proposed standard would prohibit outright swaps of corporate information for cash and little else. The implicit suggestion is that Congress should fix the law if it thinks the narrow standard leaves too much space for market abuse. Unfortunately for Salman, too much water has gone under the bridge for the Court to now repudiate its role in developing Rule 10b-5's common law of insider trading. Even if the Court wanted to abdicate the space in favor of Congress, Congress has at least ratified the idea of a common law insider trading prohibition by enacting legislation in 1984 and 1988 ramping up the penalties for insider trading.⁴⁹ For better or worse, the Court is likely stuck managing the common law of insider trading under Rule 10b-5.

How should the Court deal with the ambiguities and hard questions raised by that prohibition going forward? In my view, notwithstanding the bedrock status of *Chenery II* in administrative law, the Court should not defer to the SEC when it develops rules through adjudication if those rules carry potential criminal consequences. The Court should follow Powell's lead, as the Second Circuit did in *Newman*, by interpreting Rule 10b-5's insider trading prohibition narrowly. The Court could say, consistent with both *Dirks* and *Newman*, that an indirect personal benefit that a tipper receives from conferring a gift requires a meaningfully close personal relationship with the beneficiary. After all, Rule 10b-5 is about fraud, not carelessness,⁵⁰ and a requirement of some substantial emotional attachment for a gift to count as an indirect personal benefit would go a long way toward shoring up the amorphous line between negligence and scienter.

47. Petition for Rehearing & Rehearing En Banc at 21, *United States v. Newman*, 773 F.3d 438 (2d Cir. Jan. 23, 2015) (No. 13-1837(L)) (“[S]elective disclosure of earnings would be unlawful under SEC Regulation FD... and a jury could infer that Newman and Chiasson, as sophisticated securities professionals, knew that.”).

48. See generally Brief for Petitioner, *Salman v. United States*, No. 15-628 (U.S. May 6, 2016).

49. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984).

50. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

Construing unwritten prohibitions narrowly assuages fair notice concerns. A requirement of a substantial personal relationship would also limit the government's ability to pursue merely negligent behavior. That worry is particularly acute with respect to the SEC, which does not labor under the criminal burden of proof. Moreover, the lower courts have been quite generous in applying the elements of Rule 10b-5 to the SEC's claims. That has created real mischief when those generous precedents are applied in a criminal context, as the Government sought to do in *Newman*.⁵¹ Upholding *Newman's* meaningful personal relationship standard while affirming Salman's conviction allows the Court to take a middle course, constraining government overreach without abandoning a common law approach.⁵²

Obtaining material information of dubious province, as the *Newman* defendants did, is more of a gray area. If the SEC thinks a broad prohibition limiting the use of confidential information is essential to the health of securities markets, it should adopt such a rule, or better yet, ask Congress for legislation. Other countries have adopted statutory prohibitions to police insider trading as a form of market abuse rather than trying to cram a prohibition into the confines of common law fraud.⁵³ Either rulemaking or legislation could spell out the breadth of the insider trading prohibition explicitly, giving fair notice to individuals participating in the securities markets. SEC sympathizers will worry that a narrow decision in *Salman* would be met by legislative impasse in Congress. Some wrongdoers would then escape the punishment they deserve. But each miscreant who escapes justice will be lobbying fodder for the SEC if it decides to ask Congress for legislation. Congress, not administrative agencies, should take responsibility for enacting criminal prohibitions in a democracy committed to the rule of law.

51. In a criminal case, the government must prove that the defendant's breach is "willful," Securities and Exchange Act § 32, but the space between that standard and § 10(b)'s scienter requirement is scant, and easy for a jury to lose track of in a case of criminal securities fraud.

52. Few would doubt that helping one's brother is an indirect personal benefit. There remains the question of whether this standard is consistent with *Newman's* formulation of the test, which requires "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." *Newman*, 773 F.3d at 452. The Supreme Court is unlikely to worry much about this detail of the Second Circuit's opinion. In any event, is a brother's gratitude "a potential gain of a . . . similarly valuable nature"? Most people would not trade their sibling's love for money.

53. See generally Edward Greene & Olivia Schmid, *Duty-Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369 (discussing insider trading law in the United Kingdom and the European Union).