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SECURITIES LAW IN THE SIXTIES: THE SUPREME COURT, THE SECOND CIRCUIT, AND THE TRIUMPH OF PURPOSE OVER TEXT

A.C. Pritchard & Robert B. Thompson***

This Article analyzes the Supreme Court's leading securities cases from 1962 to 1972— SEC v. Capital Gains Research Bureau, Inc.*;* J.I. Case Co. v. Borak; Mills v. Electric Auto-Lite Co.*;* Superintendent of Insurance v. Bankers Life & Casualty Co.*; and* Affiliated Ute of Utah v. United States*—relying not just on the published opinions, but also the Justices' internal letters, memos, and conference notes. The Sixties Court did not simply apply the text as enacted by Congress, but instead invoked the securities laws' purposes as a guide to interpretation. The Court became a partner of Congress in shaping the securities laws, rather than a mere agent. The interpretive space opened by the Court's invocation of purpose allowed a dramatic expansion in the law of securities fraud. Encouraged by the Court's dynamic statutory interpretation doctrine, the Second Circuit—the "Mother Court" for securities law—developed new causes of action that transformed both public and private enforcement of the securities laws. The insider trading prohibition found a new home in the flexible confines of Rule 10b-5. Implied private rights of action encouraged class actions to flourish. The growth of fiduciary duty in the 1960s created a blueprint for "federal corporation law." The Supreme Court's "counterrevolutionary" turn in the 1970s cut back on purposivism and the doctrinal innovations of the Sixties, but the approaches to insider trading and private rights of action survived, remaining pillars of securities regulation today.*

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INTRODUCTION

The popularity of securities law rises and falls in the Supreme Court. The New Deal Court consistently provided expansive interpretations to federal securities statutes first enacted in the 1930s, while also extending substantial deference to the Securities and Exchange Commission (SEC), the watchdog agency created to administer those laws.[1] In the 1970s and 1980s, the Court just as consistently provided restrictive interpretations of the securities laws with little deference to the SEC.[2] This Article bridges the gap

1 *See generally* A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841, 844–45 (2009) ("By 1947, the New Deal Court had . . . established a pattern of expansive interpretations of the securities laws . . . [and] [t]he Court majority . . . was willing to defer broadly to the expert agency."). The first securities case to come before the Court—made up of Justices who predated the New Deal—met immediate hostility from a Court skeptical of the multitude of laws enacted to combat the Great Depression. *See* Jones v. SEC, 298 U.S. 1, 28 (1936) (denouncing SEC procedures as reminiscent of "the Star Chamber"). That initial hostility quickly faded as President Franklin Delano Roosevelt's nominees were confirmed to the Court, shifting its ideological center. Almost all of Roosevelt's eight appointees to the Court had frontline experience with the federal securities laws, either drafting the legislation, shepherding it through Congress, or defending it against constitutional challenge in court. Pritchard & Thompson, *supra* at 842–45.

2 This era dates from 1972 and the simultaneous arrival of two new conservative Justices, Lewis F. Powell, Jr. and William H. Rehnquist. Powell, an experienced corporate lawyer, was a substantial counterweight to the expert Agency. The Powell era marked a "counterrevolution," turning away from the progressive attitude of earlier periods. *See* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 847, 859 (2003) (describing the dominant influence of Powell on the Court's securities law jurisprudence). The shift of the Court's attitude toward securities law in different periods is documented in E. Thomas Sullivan & Robert B. Thompson, *The*

between the New Deal Court's enthusiastic embrace of the fledgling securities laws and the skepticism of the later era. It develops the key doctrinal contributions of the Sixties Court for securities law—a new approach to insider trading and its embrace of private causes of actions. Both survived the counterrevolution and still frame core parts of contemporary securities law.

The Sixties were volatile for securities law as they were for other aspects of American life. New Justices appointed by Presidents Kennedy and Johnson[3] along with New Deal holdover Justice William O. Douglas (previously chairman of the SEC), and support from liberal Eisenhower appointees Chief Justice Earl Warren[4] and Justice William Brennan, would push the Court's securities jurisprudence on a more interventionist path. What the Justices shared was a willingness to emphasize purpose over text in statutory interpretation. The Sixties Court was not content with simply upholding the work of Congress, as the New Deal Court had been, but instead joined as a partner in defining the securities laws to achieve their ultimate purpose. The Supreme Court, with the assistance of the SEC and the Second Circuit, produced a dramatic expansion of the law of securities fraud. The regulation of insider trading, previously cabined in a technical regime, simultaneously over and underinclusive, was reinvented as the comprehensive antifraud provision applicable today. For the first time, fraud took in pure omission in impersonal markets, a doctrinal development that had not seemed possible to litigants, jurists, and regulators in the three decades after the enactment of the federal securities laws. The Court's willingness to imply private rights of action from statutes transformed enforcement of securities laws, allowing class actions to flourish. In addition, the Court took an expansive view of fiduciary duty, creating a blueprint for a "federal corporation law,"[5] a goal long sought by progressives to address perceived weaknesses in the prevailing state law, but never enacted by Congress.[6]

Supreme Court and Private Law: The Vanishing Importance of Securities and Antitrust, 53 EMORY L.J. 1571, 1578–84 (2004).

3 President Kennedy named Byron White and Arthur Goldberg to replace Charles Whittaker and Felix Frankfurter, moving the Court from 5–4 in Justices appointed by Eisenhower to 5–4 in Justices appointed by Roosevelt, Truman, and Kennedy. Lyndon Johnson swapped Abe Fortas for Arthur Goldberg and Thurgood Marshall for Tom Clark, keeping the breakdown at 5-4, with a majority of Justices appointed by Democratic presidents. Marshall's appointment was the critical one, moving the Court in a more liberal direction, as Clark was relatively conservative.

4 Warren had been strongly opposed to the New Deal, but he was also strongly suspicious of big business based on his political experiences. JIM NEWTON, JUSTICE FOR ALL: EARL WARREN AND THE NATION HE MADE 70–71, 346 (2006).

5 Arthur Fleischer, Jr., "*Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146, 1160, 1164–66 (1965).

6 The best-known article criticizing laxity in state corporate law is by William Cary (who plays a prominent role in our story). *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). The concerns of progressives over state corporate law reach much further back, however, with Justice Brandeis

We focus on five key Supreme Court cases of the period: *SEC v. Capital Gains Research Bureau, Inc.*;[7] *J.I. Case Co. v. Borak*;[8] *Mills v. Electric Auto-Lite Co.*;[9] *Superintendent of Insurance v. Bankers Life & Casualty Co.*;[10] and *Affiliated Ute Citizens of Utah v. United States*,[11] looking not only at the published opinions but also the correspondence the Justices exchanged as those opinions were being drafted.[12] We also highlight the important role played by the Second Circuit in the development of the securities laws.[13] The Supreme Court paid scant attention to the securities laws during the 1950s, deciding only four cases between 1947 and 1962, none of which produced notable changes.[14] The Court's small securities docket during that time was matched by a slowdown in the work and budget of the SEC and little attention from Congress or the President.[15] The Agency had been exiled to Philadelphia in

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providing a frequently cited critique. *See* Louis K. Liggett Co. v. Lee, 288 U.S. 517, 541 (1933) (Brandeis, J., dissenting in part).

7 375 U.S. 180 (1963).

8 377 U.S. 426 (1964).

9 396 U.S. 375 (1970).

10 404 U.S. 6 (1971).

11 406 U.S. 128 (1972).

12 We examined the available papers of each of the Justices on the Court during this period, as we have done in the earlier and later periods in the articles. *See supra* notes 1–2.

13 Papers of the judges from the Second Circuit are not as complete as those for the Supreme Court, but the judges of that circuit long followed a practice of sharing memoranda about the cases which provided a wealth of material for us, particularly the papers of Judges Learned Hand, Charles Clark, and Henry Friendly. *See supra* notes 1–2.

14 *See* Blau v. Lehman, 368 U.S. 403 (1962); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959); Wilko v. Swan, 346 U.S. 427 (1953), *overruled by* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989); SEC v. Ralston Purina Co., 346 U.S. 119 (1953). The most prominent case of the four, *SEC v. Ralston Purina Co.*, invoked the Securities Act's remedial purpose to restrict the scope of the private offering exemption (wholly undefined in the statute), thereby preserving the SEC's regulatory reach. *Wilko v. Swan* kept securities disputes out of arbitration, allowing courts to continue to develop the securities laws. *Variable Annuity Life*, another definition case, reinforced the broad scope for the securities laws, but the papers of the Justices show some ambivalence about expanding the SEC's regulatory role. Deference to the SEC sharply dipped in the last of the four decisions, *Blau v. Lehman*, which set down textual limits on the scope of section 16(b), rebuffing the SEC's ambitious interpretation. *Blau* is discussed in more detail in Part II, where we show how the Court shifted its approach to insider trading law more generally.

The Court also heard eight Public Utilities Holding Company Act of 1935 cases during that time but they were a mopping up operation after the Court had resolved that law's vigorously contested constitutionality shortly after the end of the war. *See* Pritchard & Thompson, *supra* note 1, at 842–46.

15 Before World War II, the Roosevelt administration was bent on gaining social control over finance, and Congress had passed new securities legislation at a pace of a statute per year between 1933 and 1940. *See* Securities Act of 1933, ch. 38 title 1, 48 Stat. 74 (codified as amended in 15 U.S.C. § 77 (2012)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at scattered subsections of 15 U.S.C. §§ 77–78); Public Utility Holding Company Act of 1935, ch. 687 title 1, 49 Stat. 803, *replaced by* Public Utility Holding Company Act of 2005, Pub. L. No. 109-58, 119 Stat. 974 (codified as amended in

early 1942 to make more space for the war effort. During its first year there, the SEC produced two of the most influential rules in the Agency's history: Rule 10b-5, which today covers a broad space of shareholder antifraud litigation;[16] and Rule 14a-8, which allows shareholders to include proposals in a company's proxy.[17] But soon the Agency's output slowed.[18] In the midst of this slowdown for the Agency, as well as for the other branches of government and the Supreme Court, the Second Circuit was hard at work, particularly on the three areas that would flourish in the 1960s.

The postwar Second Circuit was well situated to take a leading role in securities law. Geographically, its location in New York City, the nation's leading commercial center and home of its largest securities markets, provided a steady source of securities cases. Location also provided its judges recurring exposure to financial innovation in securities and a sophisticated legal market on both the plaintiffs' and defendants' sides of securities litigation. The court's personnel magnified its impact. Through the 1940s, the Second Circuit had a stable bench of six long-serving members (two Roosevelt appointees joining four named by Coolidge), providing familiarity and an opportunity to develop expertise on securities cases.[19] The Second Circuit was generally recognized as distinctive.[20] It included: Judge Learned

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scattered titles of the U.S. Code); Chandler Act of 1938, ch. 575, 52 Stat. 840 (codified as amended in scattered sections of 11 U.S.C.); Maloney Act of 1938, ch. 677, 52 Stat. 1070 (codified as amended at 7 U.S.C. § 499); Trust Indenture Act of 1939, ch. 38 title 3, 53 Stat. 1149 (codified as amended in 15 U.S.C. § 77); Investment Advisers Act of 1940, ch. 686 title 2, 54 Stat. 847 (codified as amended at scattered sections of 11, 15, and 17 U.S.C.); Investment Company Act of 1940, ch. 686 title 1, 54 Stat. 789 (codified as amended at scattered sections of 11, 15, and 17 U.S.C.). When the legislative effort resumed postwar, the program was less ambitious. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 265–89 (3d ed. 2003). With the arrival of a Republican administration, Congress and the SEC became still more timid. *See* 1 LOUIS LOSS, SECURITIES REGULATION 199 (2d ed. 1961). This legislative silence continued into the early 1960s, broken by a Special Study requested by Congress that led to the Securities Acts Amendments of 1964.

16 SEC Exchange Act Release No. 3230, 1942 WL 34443, at *1 (May 21, 1942).

17 SEC Exchange Act Release No. 3347, 1942 WL 34864, at *11 (Dec. 18, 1942).

18 The Agency did not return to Washington until 1948. President Truman's appointees to the SEC had less connection to the SEC's heady New Deal era; they reflected the President's political orientation rather than any substantive policy agenda. SELIGMAN, *supra* note 15, at 242. The Eisenhower administration focused on budget restraint and the SEC's head count dropped precipitously, falling from 1723 in 1941 to 666 in 1955. *Id.* at 267–68. The Agency's agenda shrunk correspondingly. 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 298, 301 n.23 (3d ed. 1998).

19 Five of the six served twenty-four years or longer and the sixth, Jerome Frank, served sixteen years. Learned Hand and T.W. Swan continued to serve on senior status through most of the 1950s and continued to sit on key corporate and securities cases including *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), for Hand, and *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955), for Swan.

20 Professor Gerald Gunther, for example, described it as of "unmatched quality." GERALD GUNTHER, LEARNED HAND: THE MAN AND THE JUDGE 286 (1994); *see also* KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 48 (1960) (describing the

Hand, described as the best judge of the twentieth century; his cousin Judge Augustus Hand, who possessed a strong commercial background; two former deans of the Yale Law School—Judge T.W. Swan and Judge Charles Clark, the latter with strong New Deal ties and a sharply progressive attitude toward the securities laws; Judge Jerome Frank, who succeeded Douglas as SEC chair and shared his liberal instincts; and Judge Harrie Chase.[21] Even after Eisenhower started to appoint judges, this initial group, often continuing to hear cases after taking senior status, dominated the circuit's securities output. Two colleagues appointed to the Second Circuit in the 1950s and 1960s went on to the Supreme Court.[22] This strong cohort of jurists helped cement the Second Circuit's status as the "Mother Court" of securities law.[23]

The Supreme Court's activist turn in the 1960s ratified the earlier approach of the Second Circuit. Encouraged by the Supreme Court—in particular the expansive mode of statutory interpretation validated by the high court in *Capital Gains*—the Second Circuit pursued an even more ambitious agenda during the Sixties. During the 1960s, that appellate court unveiled new causes of action that ultimately transformed the enforcement of the securities law, both public and private. The Second Circuit's role would shift as it was called on to interpret this new Supreme Court precedent. The key players at the appellate court would also shift with Clark's death in 1963; Judge Henry Friendly would take the lead in the Second Circuit's development of securities law. Friendly, who joined the court in 1959, was a natural successor to Clark based on his background, although he fell short of Clark's commitment to purposive interpretation. Friendly's legal career began at Harvard Law School in the 1920s, which provided key players in the development of the securities laws of the New Deal.[24] He met Justice Felix Frankfurter even before starting law school, and Friendly's top-of-the-class record at Harvard Law School led Frankfurter to recommend him to clerk for Supreme Court Justice Louis Brandeis.[25] Friendly resisted opportunities to

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Second Circuit as "the most distinguished and admired bench in these United States"); Margaret V. Sachs, *Judge Friendly and the Law of Securities Regulation: The Creation of a Judicial Reputation*, 50 SMU L. REV. 777, 791 n.133 (1997) ("[C]ollecting tributes to the Second Circuit.").

21 Chase, sitting in Vermont, did not often travel to New York and was not within the mainstream of the court's intellectual discussion, including the securities cases. GUNTHER, *supra* note 20, at 286. The triumvirate of the two Hands and Swan who had served together since 1929 were joined by Clark, appointed to a new seat in 1939, and Frank, succeeding shortly thereafter to the chair long occupied by Judge Manton and for a short time by Judge Patterson, creating a six-person court that remained unchanged until 1951.

22 John Marshall Harlan in 1955 and Thurgood Marshall in 1967, after a stint as Solicitor General.

23 *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

24 *See* Pritchard & Thompson, *supra* note 1, at 914–17.

25 Indicative of the tight circle that linked the young Friendly and his later judicial career, Frankfurter also "selected clerks for Augustus Hand, Learned Hand, Julian Mack, and 'triennially' for then-New York Court of Appeals Judge Benjamin Cardozo." Brad Snyder, *The Judicial Genealogy (and Mythology) of John Roberts: Clerkships from Gray to Brandeis to*

teach at Harvard, turning back entreaties from Brandeis and Landis and eventually an offer from Dean Roscoe Pound.[26] Instead, he went to the Root firm[27] and then to Cleary Gottlieb and Pan American Airways, until his appointment to the Second Circuit brought him into the orbit of securities law.[28] In the midst of the change in securities law chronicled here, Friendly attended an American Bar Association (ABA) sponsored meeting to discuss the possible codification of federal securities law; he was the only participant there who was not a member of the relevant ABA committee.[29] When the American Law Institute, on which Friendly served as a member of the council and the executive committee, decided to take on a project to rewrite federal securities law, Friendly was one of two federal judges on the advisory committee.[30] Friendly became a dominant player in securities law over the next two decades.[31] His opinions on scienter in Rule 10b-5 and 14a-9 and extraterritoriality continued to be cited decades after they were written.[32]

We proceed as follows. Part I shows how the Supreme Court and Second Circuit expanded the scope of securities fraud in the 1960s, relying on fiduciary duty to create a new law of insider trading. We also highlight the critical role played by William Cary, Kennedy's appointee as chairman of the SEC. Part II turns to the recognition of implied private rights of action in the Sixties and the work of the Supreme Court and Second Circuit in fleshing out the elements of those new causes of action. Part III looks at the creation of federal corporations law. Shareholder claims against their directors were

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Friendly to Roberts, 71 OHIO ST. L.J. 1149, 1163 n.57 (2010). After Friendly's second year of law school, Frankfurter arranged for Friendly to share an apartment in New York City with two of his best students from prior classes, Thomas Corcoran and James Landis (who would later join their mentor in drafting the Securities Act), that would let them work for Frankfurter and Frankfurter's Harvard classmate, then–U.S. Attorney Emory Buckner. *Id.* at 1171–72. Friendly, unlike Corcoran and Landis, resisted the lure of Washington, declining a job offer from Eugene Meyer at the Reconstruction Finance Corporation in 1932. *Id.* at 1195.

26 *See id.* at 1194.

27 Buckner had been the lead partner at the Root firm, described by Friendly as "the only place in New York that a Jew could get a job." *Id.* at 1191 (quoting GERALD T. DUNNE, GRENVILLE CLARK: PUBLIC CITIZEN 49 (1986)). His work included, for a time, a shared assignment with future Supreme Court Justice John Marshall Harlan, who preceded him—briefly—on the Second Circuit. *Id.* at 1193.

28 The initiating incident may have been *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1966). Friendly sent his opinion to Louis Loss, generating some gentle criticism from the professor about too-broad language that might limit private causes of action. An exchange of letters led to a sentence added to the opinion, softening the holding. Sachs describes the exchange in some detail. Sachs, *supra* note 20, at 796–97.

29 *See* Louis Loss, *In Memoriam: Henry J. Friendly*, 99 HARV. L. REV. 1709, 1722 (1986).

30 *See* Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 900 (1967) (including discussion by Henry Friendly).

31 *See* Sachs, *supra* note 20, at 810 tbl.3.

32 Friendly wrote more securities opinions during the period covered by this Article than any other appellate judge—twice the number of the next highest, Lumbard and Moore, with whom he regularly disagreed. *Id.* His securities opinions were cited in casebooks more than any other judge. *Id.* at 793 tbl.2.

brought under the umbrella of federal law in response to longstanding worries about the adequacy of remedies under state corporate law. Along the way, we trace how the foundation laid in the 1950s in the Second Circuit manifested itself in the expansions of the 1960s. We also assess the degree to which the changes made by the Sixties Court survived the Supreme Court's "counterrevolutionary" turn under the influence of Justice Lewis Powell in the 1970s. We conclude with some thoughts about the role of text and purpose in interpreting the federal securities laws.

I. Insider Trading in the Sixties

Insider trading law took a dramatic turn in the 1960s. The legal focus shifted from a technical regulation in the form of section 16(b)'s mechanical disgorgement provision to a broadly defined fiduciary duty arising under Rule 10b-5's "catch-all" antifraud provision. As the 1960s dawned, there was still widespread agreement that prevailing conceptions of fraud did not and could not encompass nondisclosure in trades occurring over the anonymous exchanges of modern securities markets.[33] Affirmative lies and half-truths were covered, but the pure nondisclosure that would come to identify modern insider trading was not yet recognized as fraud when trades were between investors interacting over impersonal exchanges.[34] The SEC and the Second Circuit both played critical roles in this shift, but in three cases between 1963 and 1972, the Supreme Court's broad interpretation of fraud under the federal securities laws laid the foundation for the modern law of insider trading.

This activist turn by the Supreme Court under the rubric of fiduciary duty was somewhat surprising, given its narrow textual approach to section 16(b) in *Blau v. Lehman* at the beginning of this period.[35] Purpose prevailed over text in this period, but only when the statutory language was sufficiently open-ended to invite judicial creativity. In the 1970s, the Supreme Court would take a step back from the Second Circuit's broad view of insider trading law, but it would not repudiate nondisclosure as fraud.

A. *Section 16(b)'s Technical Regulation of Insider Trading*

The Securities Exchange Act of 1934 included section 16 designed to check profitable trading by insiders at the expense of shareholders. Misuse of inside information was a recurring topic at the hearings that led up to the

33 *See* William H. Painter, The Federal Securities Code and Corporate Disclosure 221–23 (1979) ("There is little doubt that prior to *Cady, Roberts & Co.*, the Commission envisaged Rule 10b-5, as it applied to insider training, to relate to fraud cases exclusively." (footnote omitted)). Painter also discusses congressional testimony of three SEC Chairs during the 1940s and 1950s. *Id.* at 22.

34 Professor Loss lauded this extension a major contribution, "a landmark in the law" saying "what needed to be said a long time ago." *See* William L. Cary, *Recent Developments in Securities Regulation*, 63 Colum. L. Rev. 856, 861 (1963) (involving panel discussion of Louis Loss and Carlos L. Israels); *see also* Painter, *supra* note 33, at 223.

35 Blau v. Lehman, 368 U.S. 403 (1962).

congressional legislation of the 1930s.[36] The common law of fraud, based on fiduciary duties that would later come to drive insider trading regulation under Rule 10b-5, seemed like a dead end in the 1930s. No fiduciary duty applied to trading on impersonal stock exchanges because there was no direct connection between the insider and the shareholder.[37] Instead of banning trading by insiders altogether, Congress adopted a mandatory disclosure regime for insiders who bought or sold stock in their company.[38] More intrusively, in section 16(b), Congress also required insiders to disgorge to the corporation any profits accruing from any purchase and sale occurring within six months of each other.[39] This innovative approach[40] and its broad reach provoked calls for modification or repeal from corporate America.[41] Despite these concerns about the legislation, nearly three decades would pass before the Supreme Court heard its first section 16(b) case.[42]

While the Supreme Court ignored section 16(b), the Second Circuit was busy, hearing the lion's share of section 16(b) suits in this period.[43] The Second Circuit decided twenty-one cases, with Charles Clark, an earnest advocate for regulation, sitting on fifteen.[44] Although section 16(b) cases take a back seat to Rule 10b-5 in contemporary discussions of insider trading, these early cases set the stage for the SEC's ruling in *In re Cady, Roberts & Co.*,[45] and

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36 *See* Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information,* 73 Geo. L.J. 1083, 1105 n.110 (1985).

37 *See* Donald C. Cook & Myer Feldman, *Insider Trading Under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 408 (1953) (article by SEC chair and a longtime SEC attorney noting that prior to 1934, corporate insiders were relatively free to trade in company securities under cases that found no fiduciary relationship).

38 *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at scattered subsections of 15 U.S.C. §§ 77–78).

39 *See id.* (explaining that section 16(b) applies to officers, directors, and ten percent shareholders, when they both purchased and sold shares of their company within a six-month period).

40 Cook and Feldman from the SEC observed: "We are unaware of any other statute that offers a precise analogy" to section 16(b), noting elements in the section that suggested derivative suits for damages, statutory actions for punitive damages, and an informer's cause of action. Cook & Feldman, *supra* note 37, at 408. Steve Thel argues that the statute was intended to discourage managerial abuses. Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 Hastings L.J. 391, 495 (1991) ("The scope of section 16 might be different had courts recognized it as a tool to prevent the manipulation of corporate affairs by those seeking to create trading opportunities.").

41 *See* Loss, *supra* note 15, at 1087–89 (describing section 16(b) as "probably the most cordially disliked provision" of the securities laws and describing industry and managers' recommendations for repeal).

42 *See* Blau v. Lehman, 368 U.S. 403 (1962).

43 *See* Cook & Feldman, *supra* note 37, at 640.

44 Clark's section 16(b) jurisprudence extended to two opinions published in 1963 after his death: *Gilson v. Chock Full O'Nuts Corp.*, 326 F.2d 246 (2d Cir. 1964), *aff'd on reh'g*, 331 F.2d 107 (2d Cir. 1964) (in banc) (involving reasonable attorneys' fees), and *Kornfeld v. Eaton*, 327 F.2d 263 (2d Cir. 1964) (upholding SEC power to exempt).

45 40 S.E.C. 907 (1961).

the Supreme Court's decision in *SEC v. Capital Gains Research Bureau, Inc.*,[46] and ultimately, the Second Circuit's opinions in *SEC v. Texas Gulf Sulphur Co.*[47] and the subsequent flowering of insider trading jurisprudence under Rule 10b-5.

The Second Circuit's robust section 16(b) docket meant that the court filled out much of the detail for this new statute. Panels of the circuit upheld the constitutionality of the provision three times in 1943, 1947, and 1951 before any other appellate court had taken up the constitutional questions.[48] Clark wrote the circuit's first decision, *Smolowe v. Delendo Corp.*,[49] embracing an expansive interpretation driven by the Act's purpose, rather than its text. In *Smolowe*, the court adopted the "lowest price in, highest price out" method of calculating damages that remains the section 16(b) standard.[50] Clark pushed this draconian measure based on his view of the legislative purpose to squeeze out the insider's entire possible gain. Clark's unabashedly purposivist judicial philosophy shone through in his memo to his colleagues in *Smolowe*:

> I do not hold to the view that when we think Congress has not done a clear job, we can throw up our hands and say we won't play; I think there is a clear judicial responsibility to make an act workable, if possible . . . . Moreover, by setting such a standard for Congress, we are not refusing to interpret; we are actually interpreting a certain way, while in the same breath we are practically admitting that probably we are going against what Congress would have intended had the M.C.s thought the matter through.[51]

In his role as judge, Clark saw it as his job to implement Congress's purposes in legislating, not simply to follow their textual directives as enacted.

In 1951, in *Gratz v. Claughton*,[52] Chief Judge Learned Hand (joined by A. Hand and Swan) linked Congress's purpose in passing section 16(b) to a perceived failure of fiduciary duty law. He wrote: "For many years a grave omission in our corporation law had been its indifference to dealings of directors or other corporate officers in the shares of their companies."[53] With the statute providing a mechanism to hold fiduciaries accountable, the panel reaffirmed the *Smolowe* measure, placing the risk of any uncertainty in

46 375 U.S. 180 (1963).

47 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, 401 F.2d 833 (2d Cir. 1968).

48 *See* Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir. 1947); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).

49 *Smolowe*, 136 F.2d 231.

50 *Id.* at 239.

51 Memorandum from Charles E. Clark, Judge, U.S. Court of Appeals for the Second Circuit, to Thomas W. Swan & Harrie B. Chase, Judges, U.S. Court of Appeals for the Second Circuit (Mar. 24, 1943) (on file with Charles Clark Papers, Yale University Library, Series II, Box 31, Folder 59) [hereinafter The Clark Papers] (citations omitted). Clark shared his views on interpretation at greater length in Charles E. Clark, *A Plea for the Unprincipled Decision*, 49 VA. L. REV. 660 (1963).

52 *Gratz*, 187 F.2d 46.

53 *Id.* at 49.

measurement on the wrongdoer, consistent with equity practice.[54] A 1956 case, *Stella v. Graham-Paige Motors Corp.*, decided by Frank and Learned Hand with a dissent by Judge Hincks, the first Eisenhower appointee to the court, again invoked the fiduciary reasoning of *Gratz* in holding that the initial transaction by which a person becomes a ten percent shareholder counts toward creating section 16(b) liability.[55] The interpretive theme was to read the statute broadly to stamp out the possibility of the abuses decried by Congress.

The Second Circuit opinions did not uniformly expand the reach of section 16(b), despite Clark's best efforts. In *Shaw v. Dreyfus,* a 1949 decision, Swan and Augustus Hand held, over Clark's dissent, that a gift was not a sale for purposes of the rule.[56] A panel without Clark, *Rattner v. Lehman* in 1952, decided by Swan, Learned Hand and Augustus Hand, declined to hold a partner liable for the trading of the partnership.[57] As we discuss in Section I.C below, the Supreme Court, holding that it was bound by the text of section 16(b), would follow *Rattner* a decade later in *Blau v. Lehman.*[58]

B. Rule 10b-5 Takes the Stage: Cady, Roberts *and the Modern Law of Insider Trading*

President John F. Kennedy's inauguration in 1961 set the stage for a securities law renaissance in the Supreme Court.[59] The SEC, under the lead-

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54 The situation falls within the doctrine which has been law since the days of the 'Chimney Sweeper's Jewel Case,' that when damages are at some unascertainable amount below an upper limit and when the uncertainty arises from the defendant's wrong, the upper limit will be taken as the proper amount.

Id. at 51–52 (footnote omitted).

55 Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir. 1956). Previously, in *Park & Tilford,* the panel majority of Clark and Frank found an exercise of an option would count as one of the two required transactions. The court repeated its reliance on the statutory purpose to eliminate the insider's gain. 160 F.2d 984 (2d Cir. 1947). Swan dissented on the use of redemption value versus market value. *Id.* at 991 (Swan, J., dissenting).

56 Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949).

57 Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952). Learned Hand's separate opinion noted his decision rested on the assumption that the partnership bought and sold without advice from the individual and that he "wish[ed] to say nothing" about whether the firm deputizes a partner, an issue that was presented later in *Blau v. Lehman. Id.* at 567 (L. Hand, J., concurring). Even Clark did not always give an expansive interpretation to the section. *See* Roberts v. Eaton, 212 F.2d 82 (2d Cir. 1954) (explaining statutory reclassification does not equal a purchase); Blau v. Mission Corp., 212 F.2d 77 (2d Cir. 1954) (involving stock in two corporations exchanged for stock in newly organized third corporation then distributed to shareholders; exchanges between corporations not section 16 transactions); Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954) (noting payment three years after option to not purchase or sale).

58 368 U.S. 403 (1962).

59 Kennedy commissioned a report on regulatory agencies from James Landis, a former SEC chairman and Dean of the Harvard Law School. Landis's report called for rejuvenated leadership at the administrative agencies. Letter from James M. Landis to John F.

ership of law professor William Cary, initiated an activist agenda, pushing the securities laws into corporate governance and bringing fiduciary duty into fraud. Cary had strong links to the SEC's New Deal glory days, having been a student in one of Professor William O. Douglas's last corporate finance classes and later working for Chairman Douglas at the SEC.[60] Cary signaled his intent to push the Agency in a more activist direction shortly after his arrival with his opinion for the Commission in *In re Cady, Roberts & Co.*[61] *Cady, Roberts* announced that the Agency would treat its statutory mandate to protect investors broadly, interpreting Rule 10b-5 of the Exchange Act to prohibit insider trading. The Commission had adopted Rule 10b-5 two decades earlier under section 10(b)'s authority as a general antifraud prohibition, but the rule (and statute) makes no mention of insider trading. Notwithstanding this textual omission, the SEC found in *Cady, Roberts* that the partner of a brokerage firm had violated Rule 10b-5 when he tipped nonpublic information to one of the traders at his firm. The partner had learned—in his role as a director of a public company—that the company was planning to cut the size of its dividend. In concluding that the partner had violated Rule 10b-5 by tipping, Cary set out a broad foundation for the insider trading prohibition under the antifraud rule:

> [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.[62]

These elements are conspicuously absent from the text of either Rule 10b-5 or section 10(b). Cary gave notice that in interpreting "[the] elements [of section 10(b)] under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications."[63] The SEC intended to protect "the buying public . . . from the misuse of special information."[64] The SEC would construe the securities laws to further that purpose; statutory literalism would not be an impediment. Moreover, Cary's approach also rejected the narrow confines of insider trading under state corporate law and traditional notions of fiduciary duty, most notably, the requirement of a face-to-face transaction.[65] "Relationship" and "unfairness" certainly overlap with fiduciary duty—the tipper in *Cady, Roberts*, as a

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Kennedy, Senator, U.S. Senate (Dec. 21, 1960), https://www.ratical.org/corporations/linkscopy/LandisRpt1960.pdf (issuing report on regulatory agencies to the President-Elect).

60 *See* SELIGMAN, *supra* note 15, at 293.

61 *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

62 *Id.* at 912 (footnote omitted).

63 *Id.*

64 *Id.* at 913.

65 This was a goal of Cary's before his appointment to the SEC. *See* SELIGMAN, *supra* note 15, at 344.

director, occupied a classic fiduciary position—but Cary did not use the fiduciary label to limit the reach of the concept. Indeed, Cary went so far as to proclaim the federal securities laws as being far-reaching substantive corporate law.[66]

C. *Would the Toehold Support a Paradigm Shift?* Capital Gains *as the Inflection Point*

Cary's broad vision of the SEC's authority and his new approach to insider trading had not yet been validated by a court.[67] Just a month after the SEC handed down *Cady, Roberts*, the Agency's lawyer was arguing before the Supreme Court in *Blau v. Lehman*,[68] urging that section 16(b), the explicit insider trading provision of the Exchange Act, be read broadly "on policy grounds" that echoed Cary's purposivist interpretation of Rule 10b-5 in *Cady, Roberts*.[69] The Court noted the breadth of the SEC's argument: "[It] suggest[s] that § 16(b)'s forfeiture of profits should be extended to include all persons realizing 'short swing' profits who either act on the basis of 'inside' information or have the possibility of 'inside' information."[70]

The Commission's argument was weakened, however, by its concession that "such an interpretation is not justified by the literal language of § 16(b)."[71] The statute did not prohibit insider trading across the board, but rather required disgorgement of profits made by three designated groups—"directors, officers and 10% stockholders."[72] In *Blau*, the plaintiff and the SEC urged the Court to extend that liability to a partnership (Lehman Brothers) when one of its partners was a director with knowledge of inside information and another traded the stock. The district court had found, however, that the director had not shared his knowledge of the company's affairs with the Lehman partners, and therefore, that the trading decisions had not been driven by inside information.[73] The SEC's preferred construction of section

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66 *Cady, Roberts*, 40 S.E.C. at 910 n.10 (citing McClure v. Borne Chemical Co., Inc., 292 F.2d 824, 834 (3d Cir. 1961) ("[T]he Securities Exchange Act of 1934 . . . deals with the protection of investors, primarily stockholders. It creates many managerial duties and liabilities unknown to the common law. It expresses federal interest in management-stockholder relationships which heretofore had been almost exclusively the concern of the states. . . . It can be said fairly that the Exchange Act, of which Sections 10(b) and 29(b) are parts, constitutes far reaching federal substantive corporation law.").

67 The respondents in *Cady, Roberts* did not seek review of the Agency's order, so it remained to be seen whether Cary's novel interpretation of section 10(b) would withstand judicial scrutiny.

68 368 U.S. 403 (1962).

69 *Id.* at 410.

70 *Id.* at 411.

71 *Id.*

72 *Id.*

73 *Id.* at 407.

16(b) would have made it a general prohibition against insider trading, extending disgorgement to all manner of tippees.[74] Shades of *Cady, Roberts*?

The SEC's policy arguments, however, ran afoul of the limits imposed by section 16's text. Justice Hugo Black, writing for the Court, acknowledged the SEC's "persuasive policy arguments that the [Exchange] Act should be broadened in this way to prevent 'the unfair use of information' more effectively."[75] Amending the statute, however, was not the Court's job: "Congress can and might amend § 16(b) if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made."[76] In other words, lofty policy goals would not justify an end run around plain statutory text. Moreover, the law had been settled since the Second Circuit's decision in a similar case, *Rattner*, was handed down in 1952.

The outcome had been the same in the Second Circuit.[77] Clark, who had cheered the SEC's move in *Cady, Roberts*,[78] was part of the three-judge panel that heard *Blau v. Lehman* at the Second Circuit. He dissented from the panel's decision, complaining to his colleagues that "[t]his opinion completes the job of absolutely gutting a remedial statute"[79] and lobbied hard to grant the SEC's petition to participate as an amicus and to have the case reheard (a rarity in the Second Circuit).[80] When his colleagues voted to deny the petition, Clark was nearly apoplectic. He complained that the Second Circuit's rule built "unfair discrimination . . . into an important remedial statute—a discrimination substantially eliminating the great Wall Street trading firms from the statute's operation."[81]

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74 *See generally* Brief for the SEC as Amicus Curiae, *Blau*, 368 U.S. 403 (No. 61-66), 1961 WL 102336.

75 *Blau*, 368 U.S. at 407.

76 *Id.* at 413.

77 Blau v. Lehman, 286 F.2d 786, 789 (2d Cir. 1961) (Medina, J., joined in part by Swan, J.); *id.* at 793, 796 (Clark, J., dissenting).

78 In a memorandum to his colleagues in an SEC enforcement case, Clark urged that the court support the SEC's new activism. *See* Letter from Charles E. Clark, Judge, U.S. Court of Appeals for the Second Circuit, to Thurgood Marshall, Judge, U.S. Court of Appeals for the Second Circuit (Nov. 24, 1961) (on file with The Clark Papers, *supra* note 51, at Box 43, Folder 69) ("The SEC has been moribund for eight years; it is just now coming alive—see, e.g., the fine opinion of Chairman Cary in *Matter of Cady, Roberts & Co.*, Nov. 8, 1961, S.E. Act Release No. 6668. I am not prepared to tell it to go lie down again.").

79 Memorandum from Charles E. Clark, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Jan. 11, 1961) (on file with The Clark Papers, *supra* note 51, at Box 45, Folder 186) [hereinafter Memorandum from Charles E. Clark]; *see Blau*, 286 F.2d at 796 (Clark, J., dissenting) ("[I]t would seem to me that at least before we dispose of this vastly important issue we should ask the S.E.C. for its informed comments.").

80 Memorandum from Charles E. Clark, *supra* note 80.

81 *Blau*, 286 F.2d at 799 (Clark, J., dissenting from denial of rehearing in banc).

Clark's populist tone may have struck a chord at the Supreme Court, as seven Justices voted to grant certiorari,[82] but on the merits he gained little support. His old friend Douglas dissented in an opinion that echoed Clark's moralistic tone. Douglas complained that the majority had "sanction[ed], as vested, a practice so notoriously unethical as profiting on inside information."[83] Only Warren joined Douglas;[84] even the liberal Brennan was unable to "strain the language so far."[85] The liberal bloc awaited reinforcements, as Kennedy had not yet nominated a Justice to the Supreme Court. For the SEC, *Blau* offered scant hope that either the Supreme Court or the Second Circuit would be receptive to the free-ranging method of statutory interpretation deployed by Cary in *Cady, Roberts*.

The SEC fared no better in its first efforts to use the antifraud provisions of the securities laws to reach questionable insider trading. In *SEC v. Capital Gains Research Bureau, Inc.*, argued contemporaneously with *Blau* and *Cady, Roberts*,[86] the statute at issue was the antifraud provision of the Investment Advisers Act of 1940, section 206, a provision that tracks the language of Rule 10b-5, but not completely.[87] As such, the case provided an early judicial barometer for Cary's approach in *Cady, Roberts*.

This was a time of uncertainty as to the breadth of the meaning of fraud, particularly as it might be used to regulate insider trading. The common-law action of deceit took in affirmative misrepresentations and half-truths, with the sometimes strict limits of scienter, reliance, and causation used to define the reach of appropriate recovery for damages.[88] In addition, equity courts had long supplemented the common law of deceit to provide relief for fraud.

82 Blau v. Lehman, No. 66, Docket Sheet (April 21, 1961) (on file with Earl Warren Collection, Library of Congress, Box 375) ("Grant: All but Stewart and Black who voted to deny.").

83 Blau v. Lehman, 368 U.S. 403, 419 (1962) (Douglas, J., dissenting).

84 *Id.* at 412–13 ("Not only did Congress refuse to give § 16(b) the content we are now urged to put into it by interpretation, but with knowledge that in 1952 the Second Circuit Court of Appeals refused, in the *Rattner* case, to apply § 16(b) to Lehman Brothers in circumstances substantially like those here, Congress has left the Act as it was.").

85 Justice William O. Douglas Conference Notes in Blau v. Lehman (Dec. 15, 1961) (on file with William O. Douglas Collection, Library of Congress, Box 1272).

86 *SEC v. Capital Gains Research Bureau, Inc.*, 300 F.2d 745 (2d Cir. 1961) was argued before a three-judge panel of the Second Circuit on October 13, 1961, three weeks before the SEC's decision in *Cady, Roberts* with the panel decision in *Capital Gains* on December 18, 1961. The Second Circuit heard *Capital Gains* in banc on February 22, 1962. In between, the Supreme Court decided *Blau v. Lehman* on January 22, 1962.

87 Section 206 makes it unlawful (1) "to employ any device, scheme, or artifice to defraud any client or prospective client" or (2) "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(1)–(2) (2012). This provision of the Advisers Act incorporates the substance of two of the three descriptions of fraud first enacted in section 17(a) of the Securities Act of 1933 and later incorporated into Rule 10b-5, 17 C.F.R. § 240.10b-5 (2018), but omits the part of section 17 and Rule10b-5 that specifically incorporates the common law of deceit as to affirmative misrepresentations and half-truths.

88 *See* WILLIAM L. PROSSER, THE LAW OF TORTS 686–87 (4th ed. 1971).

Those equity causes arose originally where existing forms of action were inadequate to deal with the injustices in nondamages settings. These causes were of uncertain utility in the context of a government enforcement action.[89] Early twentieth-century American cases debated the extent to which silence could come within fraud in settings when the parties were in privity.[90] By the time of the *Restatement (First) of Torts* in 1938, the drafters would include silence or omissions as fraud in a business transaction where there was a duty to disclose arising from "a fiduciary or other similar relation of trust or confidence."[91] This has become the dominant thread of modern insider trading after *Chiarella v. United States*,[92] but the *Restatement* and the *Restatement Second* published in the 1970s each contained a comment that it was "not within the scope of this Restatement to state the rules which determine the duty of disclosure which under the law of business associations the directors of a company owe to its shareholders."[93] Only a few cases had applied that principle in a corporate setting[94] and none of those cases applied such a duty to corporate insiders trading in anonymous markets.[95] *Cady, Roberts* sought to extend

89 *See id.*

90 *See* Roberts Walker, *The Duty of Disclosure by a Director Purchasing Stock from His Stockholders*, 32 YALE L.J. 637, 638 (1923); H. L. Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder*, 8 MICH. L. REV. 267, 278 (1910). Henry Manne, writing later in the 1960s, argued that insider trading was widespread and accepted. HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 9–33 (1966). Michael Perino has contested that history. Michael A. Perino, *The Lost History of Insider Trading* 2 (St. John's Sch. Law, Legal Studies Research Paper Series, No. 18-002, 2018), http://ssrn.com/abstract=3099682 (contesting Manne's depiction that insider trading was widespread and universally accepted prior to the SEC actions in the 1960s).

91 RESTATEMENT (FIRST) OF TORTS § 551 (AM LAW INST. 1938). The RESTATEMENT (SECOND) OF TORTS (AM LAW INST. 1977), drafted during the 1960s, included the same core language for silence as fraud if there is a duty to speak because of a fiduciary or other relationship of trust and confidence, and the same comment that the American Law Institute was not addressing duties within business associations. Tentative drafts ten through twelve, addressing misrepresentation, were considered by the American Law Institute during 1965 to 1967, between *Cady, Roberts* and *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (in banc). The notes, which listed many examples of fiduciary relationships—attorney-client; doctor-patient; priest-parishioner—included only one example relevant to corporate law, that of a majority shareholder to a minority shareholder illustrated by *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956). The *Restatement (Second) of Torts* was cited by *Chiarella* for the rule covering insiders within corporations. Chiarella v. United States, 445 U.S. 222, 228 n.9 (1980).

92 *Chiarella*, 445 U.S. 222.

93 *See* RESTATEMENT (SECOND) OF TORTS § 551 (AM LAW INST. 1977) (comment on clause (a)(e)); RESTATEMENT (FIRST) OF TORTS § 551 (1939) (comment on clause (a)(e)).

94 *See, e.g.*, Strong v. Repide, 213 U.S. 419, 431 (1909) (explaining ordinary relationship between director and shareholder does not require disclosure, but duty can exist by reason of special facts); Hotchkiss v. Fischer, 16 P.2d 531, 531 (Kan. 1932) (noting director negotiating with shareholder for purchase of shares acts in a relationship of scrupulous trust and confidence).

95 There was still a question as to whether duties were owed to the corporation only or to individual shareholders. *See generally* Cook & Feldman, *supra* note 37.

those limits. The resistance of the lower courts in *Capital Gains* described below shows how difficult that path would be.

The SEC enforcement action against Capital Gains Research Bureau, Inc. and its owner targeted the nebulous area between misleading half-truths and pure omissions, i.e., sharp dealing without affirmative misstatements; here the law of fraud remained unclear.[96] The SEC was pursuing inside information of a more nefarious sort than in *Cady, Roberts*—not information traders learned from others, but rather information that they themselves created in order to induce others to trade in the stock. Capital Gains published a newsletter distributed to approximately 5000 subscribers. The newsletter highlighted a number of stocks in each issue, generally predicting an increase in price.[97] The SEC alleged that on a number of occasions the defendants had purchased shares in the recommended companies prior to distributing the newsletter.[98] When the stocks increased in price and trading volume after the newsletter went out, Capital Gains liquidated its positions, usually within a week or two.[99]

The lower courts—the trial court, a three-judge panel of the Second Circuit,[100] and the in banc Second Circuit[101]—successively rejected the SEC's argument that Capital Gains' failure to disclose its purchases and subsequent sales violated section 206. They took different views about how to define fraud, but each hewed closely to the traditional common-law approach to fraud. The district court, for example, focused on the necessity of showing

96 The SEC urged that "the failure to disclose to clients to whom purchase was recommended that they (defendants), too, had made purchases, constituted a scheme to defraud by failing to disclose a material fact." SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745, 747 (2d Cir. 1961), *aff'd on reh'g*, 306 F.3d 606 (2d Cir. 1962) (in banc), *rev'd*, 375 U.S. 180 (1963). This part of the SEC's argument sounds like the half-truth species of fraud. What was the material fact? The SEC also argued that Capital Gains' "advice to buy was dishonest and fraudulent" because it failed to disclose the advisers' plan to sell its stock in the near future. *Id.* at 748. So characterized, the SEC's allegation of fraud sounds in misleading omission, applicable to any defendant; fiduciary duty arising from a relationship does not necessarily come into play. A detailed history of the enforcement action can be found in Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1056–59 (2011). Pritchard has written about *Capital Gains* previously, and this Section borrows in part from that earlier work. A.C. Pritchard, *Launching the Insider Trading Revolution:* SEC v. Capital Gains Research Bureau, *in* RESEARCH HANDBOOK ON INSIDER TRADING 33 (Stephen M. Bainbridge ed., 2013).

97 *Capital Gains*, 375 U.S. at 182–83.

98 *Capital Gains*, 300 F.2d at 747. In one case, Capital Gains had sold short the shares of a company that received a negative recommendation.

99 *Id.*

100 Two Eisenhower appointees, Leonard Moore and Sterry Waterman, made up a majority of the panel. *Federal Judicial History*, FED. JUDICIAL CTR., https://www.fjc.gov/history (last visited Sept. 18, 2018). Moore pushed back against a purposivist interpretation of the securities laws throughout the Sixties. Waterman's evolution, along with that of Henry Friendly, was key to the change in approach described in this Section.

101 The Second Circuit during this period used "in banc" rather than the now more familiar "en banc" and we follow that usage here.

the traditional elements of scienter and causation. For one subsection of section 206 to be satisfied, the SEC would have to show that Capital Gains' clients had lost money as a result of Capital Gains' sales. For the other, the SEC would have to show that Capital Gains intended to cause its clients' loss.[102]

Judge Leonard Moore's opinion for the Second Circuit's three-judge panel upheld the district court's denial of the injunction and focused on the misrepresentation element as applied to the adviser's initial statement, its recommendation of the stocks. In language suggesting more recent cases about opinions as misrepresentations,[103] Moore asked whether the statement was "honest when made" and was looking for either wrongful facts or a belief that the recommended stocks had a dismal future.[104] If the failure to disclose the adviser's subsequent sale were pursued as a basis of liability, Moore would frame it in the language of half-truth, for example requiring disclosure if the adviser "was being paid to tout a stock."[105]

The other judges who joined Moore in the in banc majority opinion picked up on one or more of these threads. Judge Paul Hays, the third Kennedy appointee to the court, concluded Congress did not intend to include "such subtleties as this failure to disclose adverse intent."[106] Also addressing the failure to disclose issue, Judge Sterry Waterman pointed to the common industry practice of advisory services to not disclose what they or their officers intend to do about stocks they recommend;[107] "at the worst" he said, it was "a

102 SEC v. Capital Gains Research Bureau, Inc., 191 F. Supp. 897, 899 (S.D.N.Y. 1961), *aff'd*, 300 F.2d 745, 747 (2d Cir. 1961), *aff'd on reh'g*, 306 F.3d 606 (2d Cir. 1962) (in banc), *rev'd*, 375 U.S. 180 (1963). The SEC, which did not fare well in the Second Circuit, won a minor concession with the appellate court's holding that the district court was wrong to require the SEC show actual losses to investors, necessarily rejecting the narrowest version of common-law fraud in interpreting section 206.

103 *See* Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1327 (2015) (addressing the status of opinions as fraud).

104 *Capital Gains*, 300 F.2d at 749. How could the court determine if the recommendation was honest? As Moore wrote to his colleagues, "the advice may be tainted with self-interest, but such a fact cannot be assumed or inferred. It must be established by proof such as deliberate misstatements of fact or belief that a stock had a dismal rather than bright future." Memorandum from Leonard P. Moore, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Oct. 17, 1961) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262).

105 *Capital Gains,* 300 F.2d. at 749.

106 Memorandum from Paul R. Hays, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Mar. 1, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262).

107 Memorandum from Sterry R. Waterman, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges 3–4 (March 1, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262). "I think what the defendant did in this case is less odious than the acts committed by losing defendants in the earlier cases involving parallel sections of the security acts. One reason for my belief is that all large investment advisers as well as large brokers and dealers regularly trade in the securities about which they advise or in which they deal. Secondly, it seems to be the custom of the trade for even brokers merely to state they 'may or may not have a position in the securities which they recommend.'" *Id.*

device by which Capital Gains could make a dollar for itself without costing its clients anything."[108] Waterman framed this as the entitlement of "an honest man honestly advising someone who is paying him for the advice" to also "handle his private affairs as he chooses."[109] Waterman's disinclination to defer to the SEC on the customs of the securities industry left him far from recognizing a fiduciary duty of disclosure. Given this "common practice," he concluded that "the stock transactions of the defendant were not clearly fraudulent or clearly a breach of trust by it to its subscribers."[110] Friendly wrote his colleagues that, both a "device, scheme or artifice to defraud" and a "transaction, practice or course of business which operates as a fraud or deceit" if "read in their ordinary sense" were lacking where the defendants did not believe that their sales would depress the price of the securities to the detriment of their customers.[111] Friendly invoked *Blau*—handed down by the Supreme Court just the month before—as a caution "against judicial expansion of provisions of the securities laws to accomplish objectives believed to be salutary."[112] He scoffed at "the liberal use of such terms as 'fiduciaries'—making people who sell an advisory service sound like trustees of an express trust."[113]

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at 4. Indeed, Waterman believed that purchasing ahead of the recommendation was validation that the recommendation was bona fide: "a purchaser of an advisory service would not think much of the advisory service or the person running it if the advisory service personnel would not buy if the recommendation was to buy." *Id.* at 3.

108 *Id.* at 1.

109 *Id.* at 2.

110 *Id.* at 4.

111 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges 2 (Feb. 26, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262).

112 *Id.*

113 *Id.* Friendly urged that Congress must have been deliberate in writing section 206 more narrowly than section 17(a): "[N]othing could have been easier than to prohibit the giving of advice which contained 'any untrue statement of a material fact or any omission' etc." *Id.* at 3. Indeed, the SEC had included similar language when it adopted Rules 10b-5 and 15c1-2. For Friendly, Congress's omission of "omission" from section 206 had interpretive consequences; labeling the investment adviser a fiduciary could not alter that conclusion, derived from the text. Text had consequences for statutory interpretation. The "etc." is interesting as the omission referred to in Rules10b-5 and 15c-1 is only mentioned in the contexts of half-truths. Pure silence, of the sort that became the basis for modern insider trading law, is not mentioned in either rule.

At the in banc oral argument, for example, Friendly pressed the SEC's counsel on whether the language of section 206 could reach defendant's conduct when section 206 included the "scheme" and "practices operating as fraud" prongs of the antifraud provision of section 17(a) of the Securities Act, but that Congress omitted the additional clause of section 17(a) that specifically prohibits affirmative misstatements or half-truths. Judge Charles E. Clark Argument Notes in SEC v. Capital Gains Research Bureau, Inc. (Feb. 21, 1962) (The Clark Papers, *supra* note 51, at Box 55, Folder 262) [hereinafter Clark Argument Notes]. Judge Friendly's inquiry of the SEC's counsel did not produce a response until all the votes were in. The SEC's response to Friendly's question was essentially, "We don't know." Letter from David Ferber, Associate General Counsel, SEC, to Judges, U.S.

Moore's opinion for the panel raised a second point that also resonated with the majority of the in banc court—the need for rulemaking:

> [W]hat the SEC would have the court do here is to create a law which Congress has never enacted or a regulation which the SEC has never promulgated which, in effect, would prohibit investment advisers or their employees from purchasing or selling any of the many stocks covered by their services.[114]

The SEC would have disclaimed any inference that its preferred interpretation would sweep as broadly as Moore suggested. The uncertainty over the contours of the SEC's interpretation of section 206, however, only reinforced the need for the specificity that a formal rulemaking could provide.[115] And rulemaking was certainly feasible; just three days after *Capital Gains* was argued in the Second Circuit, the SEC announced a proposal to amend its rules under the Investment Advisers Act to require recordkeeping of securities transactions by investment advisers and their personnel.[116] If the SEC could require recordkeeping, it could require disclosure.[117]

Clark also sat on the three-judge panel; he dissented in an opinion that echoed his shrill tone in *Blau.* The majority had "endorse[d] and in effect validate[d] a distressingly low standard of business morality," a result that "top advisers . . . not only do not desire, but find rather shocking, in the doubt thus cast upon the good faith and loyalty of all of their their profession."[118] Loyal advisers needed protection "against the stigma of the activities of unscrupulous tipsters and touts."[119] Unlike Moore, Clark stressed that

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Court of Appeals for the Second Circuit (Mar. 6, 1962) (The Clark Papers, *supra* note 51, at Box 55, Folder 262).

114 SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745, 749 (2d Cir. 1961), *aff'd on reh'g*, 306 F.3d 606 (2d Cir. 1962) (in banc), *rev'd*, 375 U.S. 180 (1963).

115 At the in banc oral argument, Judges Waterman and Lumbard wondered why the SEC had not adopted "simple rules" requiring disclosure of the trading the SEC alleged to be fraudulent. Clark Argument Notes, *supra* note 113. Judge Moore complained of the unfairness of not providing the defendant with notice. *Id.*

116 Proposal to Amend Rule 204-2 Under the Investment Advisors Act of 1940, Investment Advisors Act Release No. 120 (Oct. 16, 1961) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262).

117 Judge Waterman, who concurred in the result reached by Moore's opinion for the panel, had emphasized the need for rulemaking based on prevailing industry practice in a memorandum he prepared for the case:

> I know of no outfit that discloses what it proposes to do about the stock it or its officers may happen to own when it advises you and me what to do with our money. If the SEC wants to go into this field—and perhaps it should—it should get out some rules first.

Memorandum of Sterry R. Waterman, Judge, U.S. Court of Appeals for the Second Circuit, to Charles E. Clark & Leonard P. Moore, Judges, U.S. Court of Appeals for the Second Circuit (Oct. 19, 1961) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262). Despite his agreement with Moore on the need for rulemaking, Waterman concurred only in the result, offering no rationale for his separate position.

118 *Capital Gains*, 300 F.2d at 751 (Clark, J., dissenting).

119 *Id.* at 752.

an investment adviser was a fiduciary, whose "first duty . . . is loyalty to his beneficiary; if he is engaged in feathering his own nest, he cannot be giving his client that wholly disinterested advice which it is his stock in trade to provide."[120]

The SEC's petition for rehearing in banc generated a heated debate among the nine judges of the Second Circuit on the role of text and purpose in the interpretation of the securities laws. That debate expanded on both lines of argument in Moore's decision for the panel. Clark, seizing the initiative after oral argument, launched the first memorandum to his colleagues just one day later[121] and Friendly was quick to respond.[122] Clark rebuffed the textualist approach Friendly had set out at oral argument relying on the differences in the language of section 206 and section 17(a) to read section 206 narrowly. The language from section 17(a)(2) of the Securities Act was excluded from section 206, according to Clark, because it was unnecessary. Investment advisers do not deal directly with their clients, so including a clause relating to obtaining money or property through misrepresentation or omission "would have been a waste of ink and effort."[123] Section 206 was instead intended "to impose fiduciary obligations on those who serve as investment advisers."[124] Friendly pushed back against the broad expansion of fraud more generally as previously noted.[125]

The two jurists were also far apart on the need for rulemaking. Clark rejected the argument that the SEC should have promulgated a rule, as "quite frankly judicial legislation amending the statute, since the statute is directly prohibitory."[126] Clark urged deference to the agency:

> The SEC is indeed unfortunate in having to bring its regulatory processes before so conservative a court as ours; I wonder if any other federal appellate court would give the Commission a like run-around. I believe we should let it get on with its heavy tasks without the kind of judicial harassment it has here received.[127]

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120 *Id.*

121 Memorandum from Charles E. Clark, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Jan. 17, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262) [hereinafter Memorandum from Charles E. Clark].

122 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Jan. 22, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 26).

123 *Id.* at 3.

124 *Id.* at 3–4.

125 *See supra* notes 111–13 and accompanying text.

126 Memorandum from Charles E. Clark, *supra* note 121. *Id.* at 5 ("When Congress wanted to make a provision not self-executing, but dependent on the adoption of regulations, it knew how to do it expressly, as it did in § 10(b) of the Securities Exchange Act of 1934.").

127 *Id.* at 5.

Clark retained his New Deal faith in agency expertise even after the SEC's dormant decade. Friendly, a prominent proponent of agency rulemaking,[128] echoed Moore and Waterman in urging that Congress's 1960 addition of rulemaking authority to section 206 allowed "the SEC [to] accomplish everything it seeks."[129]

The other Second Circuit judges quickly picked sides. Clark was joined by two of the new Kennedy appointees, Judge Irving Kaufman and Judge Thurgood Marshall, and the last Eisenhower appointee, Judge John J. Smith, in voting to reverse.[130] Kaufman sharply criticized the notion that the SEC should be required to issue regulations in advance of enforcement:

> I cannot subscribe to any notion that the S.E.C. is in any way limited in its enforcement of Section 206 to the issuance of regulations prior to initiation of court action. It has been effectively pointed out that in the area of fraud and deception there can be no all-encompassing regulations. The S.E.C. should not be required to spell out the activities prohibited by the statutes any more than the courts have been made to lay down comprehensive definitions of fraud for common law purposes.[131]

Soon the tide turned, however, with the remaining judges siding with Friendly on both the narrow meaning of fraud and the need for rulemaking.[132] After Friendly, Waterman, and Hays circulated their memos, Moore

128 *See* Henry J. Friendly, *The Federal Administrative Agencies: The Need for Better Definitions of Standards,* 75 HARV. L. REV. 1263 (1962).

129 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges 1 (Feb. 26, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262). Friendly then went on to present an extended history of Congress's amendment to section 206 in 1960, from which he concluded that the power the SEC sought in this case had previously been absent from section 206, but was now available to the agency through rulemaking pursuant to section 206(4).

130 Marshall rejected the notion that "[r]egulative statutes [could be] circumscribed by common law principles." Memorandum from Thurgood Marshall, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Feb. 28 1962) (on file with The Clark Papers, *supra* note 51, at Marshall Box 8). Smith argued that Capital Gains' trading may have influenced the market price, or at least for deference to the SEC's expertise on this point. Memorandum from J. Joseph Smith, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges 2 (Feb. 28, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262) ("That such purchases and sales had some effect upon the market price of the securities is vigorously asserted by the commission, an agency presumably possessed of some expertise in the area and whose views should consequently not lightly be brushed aside.").

131 Memorandum from Iriving R. Kaufman, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges 2 (Jan. 23, 1962) (The Clark Papers, *supra* note 51, at Box 55, Folder 262).

132 See the discussion of Friendly, Hays, and Waterman, *supra* notes 106–13 (on the narrow meaning of fraud). Waterman put the two threads together concluded the narrow meaning of fraud meant "this proceeding . . . should not have been brought until after the promulgation of a rule." *Id.* at 6.

wrote tersely, "I vote to affirm."[133] With the court split 4–4, Chief Judge J. Edward Lumbard weighed in, voting to affirm.[134]

All that remained was drafting a new opinion. The writing was a somewhat delicate matter as Moore's initial effort had drawn little support from his colleagues. Moore returned to the drawing board with instructions from Lumbard to incorporate Friendly's views in his opinion.[135] Moore added Friendly's rendition of the legislative history,[136] as well as *Blau*'s caution "against excessive judicial expansion of provisions of the securities laws to accomplish objectives believed to be salutary."[137] Purpose could not trump text.

Clark's new dissent praised the securities laws extravagantly: "[T]his legislation was brilliantly successful in responding to a genuine social need. It is a prime demonstration of the capacity of a democratic government to meet a social crisis skillfully and positively."[138] The majority's opinion, however, would "scuttle the last of these highly useful statutes and leave it as but a shell."[139] The securities laws, urged Clark, should be "liberally construed to effectuate the broad remedial purpose of the acts."[140] And he rejected the suggestion that the SEC could reach the defendants' conduct through rulemaking: "[T]he hope of regulation which will require Capital Gains to meet appropriate fiduciary standards not contained in the statute is illusory indeed."[141]

After being rebuffed by the Supreme Court in *Blau v. Lehman*, the SEC had reason to be pessimistic about its prospects in *Capital Gains*. Yet, after

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133 Memorandum from Leonard P. Moore, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Mar. 2, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262).

134 Memorandum from J. Edward Lumbard, Chief Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Mar. 7, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262). Clark's personal lobbying of Hays in an effort to bring him back to the side of the Democratic appointees was unsuccessful. *See* Letter from Charles E. Clark, Judge, U.S. Court of Appeals for the Second Circuit, to Paul R. Hays, Judge, U.S. Court of Appeals for the Second Circuit (Mar. 28, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262). ("Perhaps my greatest trouble is your reliance on H.J.F.'s memo—which I'm afraid I must hold the most specious of the lot. There is just nothing to rest on in his excursions into legisl[ative] history—unfortunately a smoke screen.").

135 Memorandum from Joseph E. Lumbard, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Mar. 7, 1962) (on file with The Clark Papers, *supra* note 51, at Box 55, Folder 262).

136 SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 609–11 (2d Cir. 1962) (in banc), *rev'd*, 375 U.S. 180 (1963). .

137 *Id.* at 609 (citing Blau v. Lehman, 368 U.S. 403 (1962)).

138 *Id.* at 611–12 (Clark, J., dissenting).

139 *Id.* at 612.

140 *Id.* at 614.

141 *Id.* at 619. Clark also criticized the majority's "backward" reliance on the 1960 amendments to section 206. *Id.* at 615 ("To determine the intention of the Congress of 1940 we must look backwards from the date of passage, not forwards.").

the knockdown, drag-out fight in the Second Circuit, the SEC enjoyed a surprisingly smooth course in the Supreme Court. Five Justices voted to grant certiorari.[142] The result after argument was lopsided; only Justice John Marshall Harlan voted to affirm his former colleagues on the Second Circuit.

Justice Arthur Goldberg, one of the Kennedy appointees, was assigned the opinion. Goldberg had replaced Judge Felix Frankfurter, and like Frankfurter, Goldberg was a committed New Dealer.[143] Goldberg's jurisprudential attitude, however, could not have been more diametrically opposed to Frankfurter's. According to Goldberg's law clerk Alan Dershowitz: "The 'passive virtues,' as Professor Alexander Bickel once characterized the Supreme Court's role in *not* making decisions, was a vice to Arthur Goldberg. He wanted to get things done."[144]

Goldberg's initial circulation of his *Capital Gains* draft did not focus on the investment adviser's status as a fiduciary.[145] The language in the final opinion relating to fraud by fiduciaries was added in response to a letter from Justice Byron White, also a Kennedy appointee, who suggested that:

> [T]he treatment might be stronger if the investment adviser may be looked upon as a fiduciary . . . and if the content of fraud and deceit as applied to a fiduciary is considered . . . . If the fiduciary has a settled duty to disclose and if his failure to do so is termed fraudulent, there was little need for Congress in dealing with the fiduciary in the Investment Advisers Act to speak of anything but fraud in order to reach a failure to disclose a material fact or at the very least a conflict of interest.[146]

142 Chief Justice Warren expressed concern that the Second Circuit "ha[d] gone overboard in its opinion and gives aid + comfort to sharp dealers." SEC v. Capital Gains Research Bureau, Inc., No. 42, Docket Sheet (January 18, 1963) (on file with Earl Warren Collection, Library of Congress, Box 378) ("Grant: Goldberg, White, Douglas, Black, C.J.").

143 *See* David L. Stebenne, Arthur J. Goldberg: New Deal Liberal 8 (1996).

144 Alan M. Dershowitz, *Justice Arthur Goldberg and His Law Clerks*, *in* In Chambers: Stories of Supreme Court Law Clerks and Their Justices 295, 295–96 (Todd C. Peppers & Artemus Ward eds., 2012).

145 SEC v. Capital Gains Research Bureau, Inc., No. 42, First Circulation (Nov. 27, 1963) (on file with Northwestern University Library, Arthur Goldberg Collection, Box 17, Folder 3).

146 Letter from Byron R. White, Assoc. Justice. Supreme Court of the U.S, to Arthur J. Goldberg, Assoc. Justice, Supreme Court of U.S. (Dec. 2, 1963) (on file with Northwestern University Library, Arthur Goldberg Collection, Box 17, Folder 3). White, who had been a transactional lawyer rather than a litigator in his native Colorado, Dennis J. Hutchinson, The Man Who Once Was Whizzer White 226 (1998), was relying upon the research of his law clerk, Rex Lee, as the basis for his suggestions. *See* Memorandum from Rex E. Lee, Law Clerk, Supreme Court of U.S., to Byron R. White, Assoc. Justice, Supreme Court of U.S. 1 (undated) (on file with Byron R. White Collection, Library of Congress, Box 35, Folder 6) ("Early cases in this Court . . . indicate by dictum that a fiduciary or one who occupies a special relation to another, commits fraud when he fails to disclose a material fact."). Lee would come to play a role again in the development of insider trading law, in a more restrictive way, when, as Solicitor General, he would urge the Supreme Court to reverse the SEC's broad view of tipper–tippee liability. *See* Dirks v. SEC, 463 U.S. 646, 648 (1983).

In other words, the Second Circuit majority had erred not because it restricted section 206 to common-law fraud of affirmative misstatements or half-truths, but rather because material nondisclosure by a fiduciary was fraud per se. The Court did not search, as the appellate court did, for the badges of intentional fraud tied to affirmative misstatements. If the investment adviser was treated as a fiduciary, the common law (or at least equity) did not need to be stretched to treat nondisclosure as fraudulent.[147] No specific mention of omissions in section 206's text would be required, nor would rulemaking. Silence was fraud for a fiduciary with a duty to speak.

Goldberg quickly latched on to his fellow newcomer White's suggestion, revising his opinion to emphasize the relation between fiduciary status and fraud:

> Nor is it necessary, in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arms-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts . . . .[148]

Notable here is the lack of analysis underlying the conclusion that a newsletter publisher was a fiduciary.[149] Notwithstanding Goldberg's breezy treatment of this issue, the holding here would become the germ of the insider trading prohibition based on fiduciary duty that the Court would later recognize under section 10(b) and Rule 10b-5 of the Exchange Act.

Having used equity to free section 206 from the common-law constraints that the lower courts had imposed on it, Goldberg announced an interpretive canon that was surely music to Cary's ears: "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."[150] Having adopted this flexible/remedial interpretive canon from Clark's dissent, Goldberg brushed aside the textual differences between section 17(a) of the Securities Act and section 206 of the Investment Advisers Act: "Congress, in enacting [section 206] . . . deemed a specific proscription against nondisclosure surplus-

147 On the status of investment advisers as fiduciaries, see Laby, *supra* note 96, at 1066–78.

148 SEC v. Capital Gains Research Bureau, Inc., No. 42, Second Circulation, at 14 (Dec. 4, 1963) (on file with Byron R. White Collection, Library of Congress, Box 35, Folder 5) (footnote omitted).

149 James R. Ukropina, Note, *The Investment Advisers Act and the Supreme Court's Interpretation of Its Antifraud Provisions*, 37 S. CAL. L. REV. 359, 362 (1964) ("A more relevant inquiry from the outset might have been to ask whether or not a subscriber to a market letter costing $18 a year should be considered to have entered into a fiduciary relationship when he pays his subscription price. Further discussion of this issue would seem warranted since disputes still exist in tort law as to the nature of many relationships and the consequential necessity for disclosure.").

150 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) (quoting 3 J.G. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION 382 (Frank E. Horack Jr. ed., 3d ed. 1943)).

age."[151] Clark's ultimate victory over Friendly was secured; statutory text was no match for the flexible/remedial interpretive canon, fueled by fiduciary duty analysis.

For the SEC, *Capital Gains* was a green light to push the boundaries of its authority in other areas. Moreover, *Capital Gains* suggested that the SEC could expand its power through agency and judicial interpretation of existing statutes and regulation.[152] The Agency would not need to resort to the cumbersome rulemaking process under the Administrative Procedure Act, or, still more daunting, seeking legislation.[153] After its *Capital Gains* triumph, the SEC would push an aggressive interpretation of Rule 10b-5 to crack down on insider trading with good reason to think that the Supreme Court would support its initiative.

D. *Rule 10b-5 Occupies the Field:* Texas Gulf Sulphur

The SEC's campaign, and *Capital Gains*' interpretive approach, would find fertile ground in the Second Circuit. Clark was elated when he heard that his position had been vindicated by the Supreme Court.[154] He died only four days later,[155] but the other judges of the Second Circuit took up the SEC's cause. The Supreme Court's decision in *Capital Gains* transformed the interpretive atmosphere. Of the five-judge majority for the Second Circuit's *Capital Gains* holding overturned by the Supreme Court, Moore and Lumbard continued to resist broad holdings in securities cases, but Waterman and Smith were willing to join Friendly and the Kennedy appointees to create a consistent Second Circuit majority for expanding the securities laws through interpretation. That consensus would persist even after the Supreme Court reversed course in the 1970s.

The most dramatic expression of the Second Circuit's enthusiasm came five years after *Capital Gains*, in *SEC v. Texas Gulf Sulphur*, when the in banc Second Circuit validated the SEC's expansive reading of section 10(b) of the Exchange Act.[156] That decision is rightly credited with a critical role in the development of insider trading law under Rule 10b-5. It was a sweeping victory for the SEC, with the Second Circuit adopting—and perhaps even

151 *Id.* at 198–99.

152 *Id.*

153 On the SEC's aversion to rulemaking, see ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA (1982). Karmel laments the SEC's inclination to "formulat[e] regulatory policy through the prosecution of enforcement cases." *Id.* at 95.

154 *See* Email from Harry Reasoner, Former Law Clerk to Judge Charles E. Clark, U.S. Court of Appeals for the Second Circuit, to Adam Pritchard (May 13, 2012) (on file with authors).

155 *See Federal Judicial History*, *supra* note 100.

156 SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 859–60 (2d Cir. 1968) (in banc).

extending—the rationale of *Cady, Roberts*.[157] The court saw its holding as effectuating

> the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks . . . . [I]nequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.[158]

Texas Gulf Sulphur illustrates the change in regulatory approach to insider trading under federal law that took place in the 1960s. The *Texas Gulf Sulphur* majority included three members of the Second Circuit's five-man majority in *Capital Gains* that just five years before had held that the antifraud provisions of the federal securities laws should be narrowly interpreted and that any expansion should come via agency rulemaking. They now abandoned those concerns, expanding fraud under Rule 10b-5 to cover pure omissions in open-market settings.[159] Waterman—who had characterized the conduct in *Capital Gains* as making "a dollar for [Capital Gains] without costing its client anything"—now wrote the opinion enthusiastically endorsing the SEC's position. He was joined by Friendly and Hays from the *Capital Gains* majority overturned by the Supreme Court. Swept aside were the messy debates over the nuances of affirmative misstatements, half-truths, and the traditional badges of common-law fraud that had so occupied the circuit in *Capital Gains*. It was now accepted—without discussion—that fraud included silence by insiders when they had a duty to speak.[160]

What had changed? The sweeping language of *Capital Gains* seems to have freed the Second Circuit to embrace the expansive approach of *Cady, Roberts* in interpreting Rule 10b-5.[161] Just over a year after *Capital Gains*,

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157 *Id.* at 848 ("[A]nyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public." (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961))).

158 *Id.* at 851–52. Steve Bainbridge has argued that this understanding of congressional purpose is not supported by the legislative history. *See* Stephen M. Bainbridge, *Equal Access to Information: The Fraud at the Heart of* Texas Gulf Sulphur, 71 SMU L. REV. 643 (2018).

159 The circuit's majority position in *Capital Gains* was not an outlier. Professor William Painter collected statements of three SEC Chairs in the 1940s and 1950s concluding, "[I]t is extremely doubtful that prior to the *Cady, Roberts & Co.* case the Commission envisaged Rule 10b-5 as having any real application to insider trading beyond the fraud area," and fraud did not yet stretch to the nondisclosure space that Bill Cary envisioned for it. *See* PAINTER, *supra* note 43, at 223 (1979).

160 The in banc judges of the Second Circuit debated numerous issues of the case including materiality and when insiders can trade, but their exchange of letters and memoranda does not reveal any discussion about whether nondisclosure could fall within the definition of fraud.

161 *See* Daniel B. Posner, *Developments in Federal Securities Regulation*, 20 BUS. LAW. 595, 606 n.37 (1965) ("While the Capital Gains case relied principally on the fiduciary obligation of an investment adviser . . . there are many statements in the opinion which appear to

Waterman wrote for the Second Circuit in *List v. Fashion Park, Inc.*, showing an openness to extending fraud to nondisclosure that had been missing in *Capital Gains*.[162] *List* involved a face-to-face transaction (for which there was some earlier precedent to cover nondisclosure), but Waterman's rejection of defendant's argument that 10b-5 did not apply to complete nondisclosure went further, anticipating the holding in *Texas Gulf Sulphur* that nondisclosure in an impersonal market setting could be considered fraud.[163]

Litigants and legal commentators at the time recognized this evolution. A lawyer representing one of the director-defendants in *Texas Gulf Sulphur* acknowledged that if the SEC position in that case were sustained, it would "simply sound the death knell to any argument that you can be safe by keeping quiet."[164] Speaking at the same forum in 1965, Cary expressed confidence that the courts would continue the path he had blazed in *Cady, Roberts*:

> I have no doubt whatsoever that when management is engaged in trading, the courts will label nondisclosure as a violation of the third clause of 10b-5. Despite arguments to the contrary, that gaping hole will not be allowed to remain ajar, even vis á vis complainants who bought or sold on the open market.[165]

The district judge affirmed by the Second Circuit in *Texas Gulf Sulphur* held that the statute and rule go at least as far as federal common law, interpreted to extend liability for failure to disclose to purchasers on national

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be in direct support of the view that the Federal securities statutes contain prohibitions against non-disclosure of material facts, as distinct from prohibitions against half truths misleading through non-disclosure.").

162 List v. Fashion Park, Inc., 340 F.2d 457, 461 (2d Cir. 1965).

163 The doctrine for which defendant Lerner contends would tend to reinstate the common law requirement of affirmative misrepresentation. . . . [T]he effect of adopting such a doctrine would be automatically to exempt many impersonal transactions. This effect would be contrary to the intent of Congress, as set forth in Section 2 of the Securities Exchange Act.

Id. at 462. Don Langevoort develops this point in a recent essay. Donald C. Langevoort, *From* Texas Gulf Sulphur *to* Chiarella*: A Tale of Two Duties*, 71 SMU L. REV. 835 (2018). ("Analytically, that is the key step in seeing insider trading as fraud."). Langevoort shows the linkage between the move away from the traditional privity requirement and the relaxation of the reliance requirement which followed and the judicial willingness to bring complete nondisclosure within fraud. *Id.*

164 Symposium, *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1025 (1966) [hereinafter *Insider Trading*] (panelist Thomas Halleran noting that there was some argument prior to *Cady, Roberts* that Rule 10b-5 should not impose liability for failure to make a disclosure as distinguished from half-truth); *see also* W. McNeil Kennedy & Herbert S. Wander, Texas Gulf Sulphur*, A Most Unusual Case*, 20 BUS. LAW. 1057, 1062 (1965) (recognizing that a question has always existed whether omissions as distinguished from half-truths was a violation; if the SEC is successful in *Texas Gulf Sulphur*, it will mean that total silence will not insulate).

165 *Insider Trading*, *supra* note 164, at 1014 (remarks of William L. Cary).

securities exchange: "Lack of communication between defendant and plaintiff does not eliminate the possibility that Rule 10b-5 has been violated."[166]

The Supreme Court's opinion in *Capital Gains* would be cited by the *Texas Gulf Sulphur* majority for the proposition that even negligent insider trading would be unlawful.[167] *Capital Gains* was cited not only for that remarkable proposition, but also for the flexible/remedial interpretive presumption: "[T]he securities laws should be interpreted as an expansion of the common law . . . to effectuate the broad remedial design of Congress."[168] Lumbard and Moore found themselves in dissent, forced to give lip service to *Capital Gains*'s flexible/remedial interpretive canon, but refusing to follow it to its logical conclusion.[169]

The Second Circuit, taking its cue from the Supreme Court's interpretive approach in *Capital Gains*, now viewed itself as the partner of the SEC in correcting market inequities. Chairman Cary's aggressive approach to insider trading in *Cady, Roberts* now had been validated by the "Mother Court" for securities law. The Supreme Court let the issue percolate, denying certiorari in *Texas Gulf Sulphur*.[170] But *Capital Gains* had already established that silence could be fraud under federal securities law so long as there was a duty to speak.

The Supreme Court would not squarely address the central issue of the applicability of Rule 10b-5 to insider trading for another dozen years, but in the interim it sent conflicting signals. Several additional section 16(b) cases suggested textualism's demise may have been exaggerated, at least in that setting. A Rule 10b-5 case however—*Affiliated Ute Citizens of Utah v. United States*—reaffirmed the purposive interpretive approach.[171] Justice Harry Blackmun, newly appointed by Richard Nixon after two prior nominees failed to be confirmed, kept the remedial spirit of *Capital Gains* alive.

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166 SEC v. Tex. Gulf Sulphur Co., 258 F. Supp. 262, 279 (S.D.N.Y. 1966) (quoting Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962)), *aff'd in part and rev'd in part*, 401 F.2d 833 (2d Cir. 1968). .

167 *Texas Gulf Sulphur*, 401 F.2d at 855 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)); *see also* Memorandum from Irving R. Kaufman, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (May 14, 1968) (on file with Henry Friendly Collection, Box 135, Folder 51) ("While I am attracted to HJF's proposal of limiting § 10(b) to cases where there is some kind of evil motive, or, in Loss' terms, imposing a watered-down scienter requirement, it seems to me that such an explicit formulation goes against the thrust of S.E.C. v. Capitol [sic] Gains Research Bureau." (citation omitted)).

168 *Texas Gulf Sulphur*, 401 F.2d at 855 (footnote omitted).

169 *Id.* at 886 (Moore, J., dissenting). In the years since *Capital Gains*, Henry Manne published his book setting forth an economics-based endorsement of insider trading. *See generally* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). That issue did not enter into the Second Circuit's opinion or the memoranda exchanged by the judges.

170 The Supreme Court denied the petition for writ of certiorari filed by Texas Gulf Sulphur's general counsel over the dissent of Justice White. Kline v. SEC, 394 U.S. 976 (1969); *see also* Coates v. SEC, 394 U.S. 976 (1969) (denying petition of Texas Gulf Sulphur insider held liable for negligent insider trading).

171 Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

After reviewing the briefs in *Reliance Electric Co. v. Emerson Electric Co.*,[172] Blackmun homed in on the connection between section 16(b) and section 10(b):

> Section 16(b) contains a provision for exemptions from short-swing liability when the SEC so rules. Section 10(b), on the other hand, seems to relate directly to profits gained by the use of inside information. Thus, if a proper intent can be proved, § 10 leads to liability irrespective of any 10% holding.
>
> One could argue from the foregoing that the 10% rule is to be rather narrowly applied, viz, that one has to have 10% both at the time of purchase and at the time of the offending sale. This is a forceful argument.
>
> My own reaction generally, on the other hand, is that § 16(b) should be rather broadly interpreted. It was enacted and aimed at a specific abuse. We have some precedent for broad interpretation . . . . [T]he statute is not to be strictly construed. One can be over-literal in this business.[173]

For Blackmun, the case was a challenging one, but he favored the expansive approach:

> [T]here are potent arguments on both sides of this case and, however one comes down, he has to deal with weaknesses in his position. I still am basically inclined to take the liberal approach in this one and to give the greater force to the evident purpose of the statute . . . . I am fairly certain the Court will divide on this and may well find myself in the minority with some strange companions.[174]

Despite his inclination for the "liberal approach" to promote the statute's "evident purpose," Blackmun did not, in the end, side with the minority of his colleagues in the case who favored liability. Instead he signed on to the majority opinion, authored by Justice Potter Stewart, which hewed closely to the language of the statute.[175] The interpretive freedom embraced

172 404 U.S. 418 (1972).

173 Notes of Harry A. Blackmun, Assoc. Justice, Supreme Court of U.S. 3 (Nov. 9 1971) (on file with Harry Blackmun Papers, Library of Congress).

174 *Id.* at 4. Blackmun's preference for a liberal approach to section 16 was long standing. *See* Petteys v. Butler, 367 F.2d 528, 538 (8th Cir. 1966) (Blackmun, J., dissenting) ("My own reaction is that either the statute means what it literally says or that it does not; that if the Congress intended to provide additional exceptions, it would have done so in clear language; and that the recognized purpose and aim of the statute are more consistently and protectively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case application. The latter inevitably is a weakening process.").

175 *See Reliance Electric*, 404 U.S. at 423 ("Read literally, this language clearly contemplates that a statutory insider might sell enough shares to bring his holdings below 10%, and later—but still within six months—sell additional shares free from liability under the statute."). The clarity of the text left no room for recourse to statutory purpose: "[W]hatever the rationale of the proviso, it cannot be disregarded simply on the ground that it may be inconsistent with our assessment of the 'wholesome purpose' of the Act." *Id.* at 424.

The Court also rejected "a judicial search for the will-o'-the-wisp of an investors 'intent'" as insufficiently objective. *Id.* at 425. Finally, the majority rebuffed the SEC's by *Capital Gains* and *Texas Gulf Sulphur* appeared to bypass section 16 entirely.[176]

Section 10(b), however, was still available, and its open-ended language invited the broad interpretive approach so enthusiastically endorsed by the Supreme Court in *Capital Gains.* Blackmun, after reading the briefs in *Affiliated Ute Citizens of Utah v. United States*,[177] another case heard the same term as *Reliance Electric*, was looking for a way to decide for the plaintiffs, Native American tribe members:

> I am inclined to read the Securities Exchange Act broadly, and to permit it to reach this kind of fraudulent practice despite the absence of specifically alleged and proved reliance. Of course, the identity of these plaintiffs as Indians, or at least mixed bloods, makes this a little easier than it otherwise might be. There is enough here, however, to establish misrepresentation and concealment. I feel we should plump for a high standard in this area, and this is in line with the intent of Congress in enacting the legislation.[178]

Blackmun, like Brennan, had been a student in Frankfurter's legendary Public Utilities class at Harvard, and Blackmun had endorsed Frankfurter's judicial philosophy during his confirmation hearings.[179] He showed none of Frankfurter's judicial restraint, however, when it came to the law of securities fraud. Assigned to write for the majority, Blackmun cited *Capital Gains* for the proposition that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'"[180] The flexible/remedial interpretive move allowed the *Affiliated Ute* Court to excuse proof of reliance

policy plea for broadening coverage as properly directed to Congress, echoing Black's position in *Blau* a decade earlier: "[W]e are not free to adopt a construction that not only strains, but flatly contradicts, the words of the statute." *Id.* at 427.

176 Douglas's dissent could have been written by his old friend Charles Clark: "In my view, this result is a mutilation of the Act, contrary to its broad remedial purpose, inconsistent with the flexibility required in the interpretation of securities legislation, and not required by the language of the statute itself." *Id.* at 428 (Douglas, J., dissenting). Textualism should not be allowed to defeat the purpose of the act: "[S]hould the broadly remedial statutory purpose of § 16(b) require it, the literal language of the statute would not preclude an analysis in which the two transactions herein at issue are treated as part of a single 'sale.'" *Id.* at 434. For Douglas, the text was at most a constraint on achieving purpose, not a directive to be applied by courts, and even the technical language of section 16(b) was not sufficiently precise to constrain. Only Brennan and White, however, joined in his free-ranging interpretive approach; the liberal stalwarts, Goldberg and Warren, had left the Court. On the friendship of Douglas and Clark, see William O. Douglas, *Charles E. Clark*, 73 YALE L.J. 3, 3 (1963).

177 406 U.S. 128 (1972).

178 Memorandum of Henry A. Blackmun, Assoc. Justice, Supreme Court of U.S. 3 (Oct. 18, 1971) (on file with Harry Blackmun Papers, Library of Congress).

179 *See* SETH STERN & STEPHEN WERMIEL, JUSTICE BRENNAN: LIBERAL CHAMPION 24, 348 (2010).

180 *Affiliated Ute*, 406 U.S. at 151 (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)).

under Rule 10b-5 in cases "involving primarily a failure to disclose,"[181] the equitable notion of fraud endorsed in *Capital Gains*. Thus, the Court took another step toward validating an insider trading prohibition under the rubric of Rule 10b-5, while at the same time broadening the availability of a private cause of action, a topic we address in Part II. By extending the interpretive approach of *Capital Gains* to Rule 10b-5, the Supreme Court also implicitly endorsed the Second Circuit's approach in *Texas Gulf Sulphur*.

E. Insider Trading Retrenchment and Renewal

Powell's first insider trading opinion under Rule 10b-5, *Chiarella v. United States*,[182] did not reject *Cady, Roberts* or *Texas Gulf Sulphur* outright, but construed them narrowly, confining those decisions within a common-law framework.[183] Powell's opinion for the Court declined to hold Chiarella liable for insider trading using information he had learned from his job as a printer setting type for tender offer announcements in newspapers. Powell held that Chiarella owed no fiduciary duty to the shareholders of the target firm with whom he traded (anonymously) in transactions over a stock exchange.[184] As Powell saw it, the common law of fraud required a duty to the counterparty to the transaction.[185] Despite his reliance on common-law principles, Powell was following the Second Circuit in acknowledging that fraud could include silence (as well as affirmative lies and half-truths), so long as the defendant who traded had a duty to speak. Powell's justification for relying on fiduciary duty? "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."[186] Powell recognized that treating insider trading as fraud also implicated corporate governance. He incorporated silence into the definition of fraud under Rule 10b-5, if the trading was done by one with the traditional duty that officers and directors owe their shareholders. He wanted, however, to keep that body of law firmly rooted in disclosure, which he saw as the province of federal law. He distrusted the SEC's efforts to expand its authority through interpretation of the securities laws: "[T]he SEC should have gone to Congress long ago. Rather, it has elected to write expansive Rules (e.g., Rule 10b-5, drafted by Louis Loss one morning), and then undertake to extend the vague language of the Rule to the edge of rationality."[187] Powell used traditional notions of fiduciary duty as his doctrinal tool to confine the SEC's aggressive interpretations of

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181 *Id.* at 153.

182 445 U.S. 222 (1980).

183 *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, 19 (1998).

184 *Chiarella*, 445 U.S. at 232–33.

185 *Id.* at 228.

186 Id. at 234–35.

187 Letter from Lewis F. Powell, Jr., Assoc. Justice, Supreme Court of U.S., to Michael P. Dooley, Professor of Law, Univ. of Va. 1 (Oct. 25, 1980). Powell's assertion that Loss drafted Rule 10b-5 is incorrect. *See* Freeman, *supra* note 30 at 922 (1967) (including discussion by Milton Freeman who claimed authorship of Rule 10b-5).

"vague language" of Rule 10b-5. Vagueness was a vice to be curtailed, not an opportunity for expansion interpretation.

Three years later, Powell's opinion for the Court in *Dirks v. SEC*[188] followed a similar template, permitting the insider trading rule to extend to tippees but limiting liability for tippees to those who trade on information from insiders who have breached their fiduciary duty. Absent a breach by the insider in disclosing the information, the tippee could not be liable.[189] This is a far distance from the Second Circuit's "equal access" approach in *Texas Gulf Sulfur*, which Blackmun had left undisturbed in *Affiliated Ute*.

Powell did not have the last word on insider trading, however, as his retirement led to a 4–4 split in *Carpenter v. United States*; the misappropriation theory survived that decision to be considered another day.[190] Had Powell stayed, he would have provided the fifth vote rejecting the theory. Almost a decade later, the Court would validate the theory by a 6–3 vote in *United States v. O'Hagan*.[191] The SEC also fought a rearguard action against Powell's tipping doctrine, adopting Regulation FD as a disclosure rule for public companies in 2000.[192] Regulation FD prohibited selective disclosure of the sort that Powell had worked to protect in *Dirks*. Powell's counterrevolution was dramatic, but he did not succeed in completely constraining the SEC in the field of insider trading.

II. Private Rights of Action

We saw in Part I how the Supreme Court gave a green light to purposive interpretation of the securities laws to combat information asymmetry. That signal from the high court encouraged the Second Circuit, pushed by the SEC, to lay the groundwork for the modern law of insider trading under Rule 10b-5. Of greater economic significance, however, was the Supreme Court's encouragement of private causes of action in the 1960s. The securities laws include a number of express private causes of action—sections 11 and 12 of the Securities Act, and (less frequently deployed) sections 9 and 18 of the Exchange Act. These causes of action were little used, however, before the revision of Rule 23 of the Federal Rules of Civil Procedure in 1966.[193] The new Rule 23 created the procedural structure undergirding the modern class action. Of equal significance in securities law, however, was the judicial discovery of implied private causes of action under the Exchange Act. The

188 463 U.S. 646 (1983).

189 *Dirks*, 463 U.S. at 659.

190 Carpenter v. United States, 484 U.S. 19, 24 (1987). Powell had voted to have the Court hear the case, but he left before the case was decided. *See* Pritchard, *supra* note 183, at 16.

191 521 U.S. 642, 676 (1997).

192 *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 7881, 2000 WL 1201556 (Aug. 15, 2000).

193 *See* Lawrence D. Bernfeld, *Class Actions and Federal Securities Laws*, 55 Cornell L. Rev. 78, 78 (1969); Jill E. Fisch, *The Trouble with* Basic*: Price Distortion After* Halliburton, 90 Wash. U. L. Rev. 895, 900–11 (2013).

Supreme Court's opening of the floodgates for securities class actions in the 1960s shares two characteristics with the evolution of insider trading law discussed in the previous part. First, the principal weapon was the open-ended language of Rule 10b-5. Second, the Second Circuit would again play a critical supporting role.

In this Part, we discuss how the Supreme Court interpreted the securities laws to afford investors remedies beyond those provided by the common law or—at least explicitly—by statute. As with insider trading, the enterprise was driven by an expansive understanding of congressional purpose, only minimally constrained by reference to statutory text. We also explore how the Second Circuit worked to flesh out the details of these implied causes of action in the absence of statutory guideposts. The joint effort of the two courts would create a cottage industry of securities fraud class actions, eventually generating billions of dollars in settlements and attorneys' fees. As with insider trading, the Supreme Court would take a step back in the 1970s. The Second Circuit would struggle with that retrenchment, resisting efforts to undo its handiwork from the 1960s.

A. *The Second Circuit Lays the Foundation*

Rule 10b-5, promulgated by the SEC in 1942, was first recognized as creating a private action by *Kardon v. National Gypsum Co.*, a 1947 district court decision.[194] The Supreme Court did not take up the issue of implied rights of action under the securities laws until *J.I. Case Co v. Borak* in 1964, which recognized a private cause of action under Rule 14a-9, the parallel antifraud provision under the proxy rules,[195] and *Superintendent of Insurance* v. *Bankers Life & Casualty Co.* in 1971, which held, in a footnote, that there was a private right of action under Rule 10b-5.[196] In between, the Second Circuit did the heavy lifting on private rights of action.

Fischman v. Raytheon Manufacturing Co., a 1951 decision written by Frank joined by Swan and Chase, made the Second Circuit the first appellate court to follow *Kardon* in implying a Rule 10b-5 private right of action.[197] A decade later, Louis Loss listed in his treatise three other circuits with holdings similar to *Fischman* (and one with dictum).[198] Second Circuit jurisprudence seems to have influenced most of these decisions, but these other circuits looked back beyond *Fischman* to earlier Second Circuit opinions written by Charles Clark. The Ninth Circuit's 1953 opinion in *Fratt v. Robinson*, for example, cites *Fischman*,[199] but the text relies on the reasoning of Clark's separate opinion in *Baird v. Franklin* from 1944.[200] The *Baird* panel—Augustus Hand,

194 Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

195 J.I. Case Co. v. Borak, 377 U.S. 426, 430 (1964).

196 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

197 Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951).

198 1 Loss, *supra* note 15, at 1760 n.260.

199 Fratt v. Robinson, 203 F.2d 627, 632 n.15 (9th Cir. 1953) (citing *Fischman*, 188 F.2d at 787).

200 Baird v. Franklin, 141 F.2d 238 (2d Cir. 1944).

Swan, and Clark—affirmed the trial court on the absence of proven damages,[201] but Clark's separate opinion passionately endorsed a private cause of action under section 6(b) of the Exchange Act.[202] The Third Circuit in 1956 in *Speed v. Transamerica Corp.* affirmed a district court decision that had found a private cause of action under Rule 10b-5.[203] The district court, in turn, had relied on another Second Circuit opinion, *Charles Hughes & Co. v. SEC*, a 1943 decision by Clark, which had emphasized the broad purposes of the securities laws.[204]

This linkage of the private right of action question to the broad purposes of the act is also apparent in Frank's dissent in *Subin v. Goldsmith.*[205] Frank saw a critical policy role for private litigation:

> An economy like ours, which thrives on the fact that thousands of persons of modest means invest in corporate shares, will be poorly served if our courts regard with suspicion all minority stockholders' suits, and, therefore, out of desire to discourage such suits, apply to them unusually strict pleading rules, thus tending to thwart judicial inquiries into the conduct of wrongdoing, controlling stockholders. The unfortunate consequences will be that those in control may be immunized from effective attacks on their misdeeds, and, as a result, the small investors will lose confidence in all corporate managements, the honest as well as the dishonest.[206]

Frank's views would resurface—only to be rejected—forty years later when Congress debated the Private Securities Litigation Reform Act.[207]

Despite its generally liberal focus on purpose, at other times the Second Circuit could be more textual—and hence, more restrictive—in its approach to implied private rights of action, at least when Clark did not sit with the

201 *Id.* at 239.

202 *Id.* at 244–45 (Clark, J., dissenting in part) ("If these aims are to be followed . . . if the investing public is to be completely and effectively protected, § 6(b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges.").

203 Speed v. Transamerica Corp., 235 F.2d 369, 374 (3d Cir. 1956).

204 Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943) (revoking broker-dealer registration against a challenge of unconstitutional delegation to an agency and noting that "[s]uch protection will mean little if it stops short of the point of ultimate consequence"). That decision led to a laudatory letter from Louis Loss, who had worked at the SEC as an attorney, to Clark. Letter from Louis Loss, Professor of Law, Harvard Univ., to Charles E. Clark, Judge, U.S. Court of Appeals for the Second Circuit (Dec. 17, 1962) (on file with The Clark Papers, *supra* note 51, Series II, Box 31, Folder 62).

205 224 F.2d 753 (2d Cir. 1955).

206 *Id.* at 767 (Frank, J., dissenting). Frank's dissent is quoted by the Sixth Circuit in *Dann v. Studebaker*, an important pre-*Borak* opinion on a private right of action under section 14(a), with the court noting "we are much influenced by the sound policy considerations set forth by Judge Frank in his dissent." Dann v. Studebaker-Packard Crop., 288 F.2d 201, 209 (6th Cir. 1961).

207 *See, e.g.*, Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 765 (codified as amended in scattered subsections of 15 U.S.C. §§ 77–78 (2012)) (noting that both the House and Senate voted to pass the bill by two-thirds majorities to overcome a presidential veto).

panel. Most famously, in *Birnbaum v. Newport Steel Corp.*,[208] a panel of Learned Hand, Augustus Hand, and Swan applied the purchaser/seller language of Rule 10b-5 to require the plaintiff allege an actual purchase or sale influenced by the misrepresentation. Excluded from Rule 10b-5 standing were nonselling shareholders who alleged harm by insiders misusing their fiduciary authority to sell control shares to a third party for a premium not shared with the shareholders generally.[209] It was the *Birnbaum* rule that the Supreme Court embraced two decades later in *Blue Chip Stamps v. Manor Drug Stores*, the first shot in the Supreme Court's 1970s counterrevolution in securities law.[210]

The Second Circuit was also slower to embrace a private cause of action for Rule 14a-9 than for 10b-5.[211] Rule 14a-9 of the Exchange Act prohibits the use of false and misleading statements in the solicitation of a proxy for a public company.[212] In *Subin v. Goldsmith*, Judge Harold Medina's opinion for the panel majority left open whether section 14(a) could be construed as creating substantive rights in an individual shareholder.[213] Another panel of the Second Circuit did the same the following year in *Howard v. Furst*.[214] In *Brown v. Bullock* in 1961, Friendly, writing for the in banc court, found a private cause of action under the Investment Company Act.[215] The implication of a private right of action provoked a dissent from Leonard Moore. Clark concurred only in the result, writing to say, "I suspect that some day we

208 Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952).

209 *Id.* at 464. This topic is the focus of the Section II.B. *See infra* notes 217–24 and accompanying text.

210 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 723 (1975).

211 This would change with the Supreme Court's 1964 decision in *Borak*. *See infra* notes 217–24 and accompanying text.

212 17 C.F.R. § 240 14a-9(a) (2018) ("No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.").

213 Subin v. Goldsmith, 224 F.2d 753, 774 (2d Cir. 1955). The majority of the panel, Medina and District Judge Brennan, were doubtful of substantive rights under section 14 but did not need to reach that since the factual allegations were insufficient for a claim. Frank's dissent would provide substantial room for minority shareholders to pursue misdeeds as discussed above. *Id.* at 767 (Frank, J., dissenting).

214 238 F.2d 790, 791 (2d Cir. 1956) (Judges L. Hand and Hincks joining Medina on the panel).

215 Brown v. Bullock, 294 F.2d 415, 418 (2d Cir. 1961) (in banc). Friendly noted: "I might be more inclined to stretch a point in Leonard[Moore's] direction if I did not feel that Congress would be quite happy to have these suits relating to mutual funds in the Federal courts." Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Aug. 30, 1961) (on file with Henry Friendly Collection, Harvard Law School Library, Box 138, Folder 8).

shall have to disavow the much criticized case of Howard v. Furst . . . ."[216] Clark was eager to overcome all obstacles to the private enforcement of the securities laws.

B. The Supreme Court's Casual Embrace

The revolution in implied rights of action began quietly. At issue in *J.I. Case Co. v. Borak*[217] was whether a shareholder unhappy with a merger could enforce Rule 14a-9's prohibition in an action for rescission or damages. Absent a private right of action, the prohibition could only be enforced by the SEC or the Department of Justice; the shareholder would be left to his remedies under state corporate law. Invoking the "broad remedial purposes" of fair corporate suffrage and discouraging abuse of the proxy process, Justice Tom Clark, writing for the Court, brushed aside the fact that section 14(a)'s "language makes no specific reference to a private right of action, [because] among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."[218] Having discerned that broad mandate from the purpose of investor protection, Clark moved on to conduct his own policy analysis to effect that purpose. He concluded that judicial relief was necessary: "Private enforcement of the proxy rules provides a necessary supplement to Commission action," given the volume of proxies the SEC had to review.[219] That need was sufficient to trigger "the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."[220]

The statutory hook for this judicial lawmaking was found in section 27 of the Exchange Act. That section confers jurisdiction on the district courts over "all suits in equity and actions at law brought to enforce any liability or duty created by this title."[221] The Court invoked its New Deal era *Deckert v. Independence Share Corp.* decision, interpreting similar language in the Securities Act:

> The power *to enforce* implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case.[222]

The Court did not mention that the "right of recovery" in *Deckert* was an explicit cause of action (section 12 of the Securities Act). Nor did the *Borak* Court mention the explicit private rights of action created in the Exchange

216 *Brown*, 294 F.2d at 422 (citation omitted).

217 377 U.S. 426 (1964).

218 *Id.* at 431–32.

219 *Id.* at 432.

220 *Id.* at 433.

221 *Id.* (quoting Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at scattered subsections of 15 U.S.C. §§ 77–78(2012))).

222 *Id.* at 433–34 (quoting Deckert v. Indep. Shares Corp., 311 U.S. 282, 288 (1940)).

Act (sections 9, 16, and 18). A structural interpretation of the Exchange Act might have concluded that Congress intended those explicit causes to be exclusive. The Court also dismissed possible interference with state law: "[I]f the law of the State happened to attach no responsibility to the use of misleading proxy statements, the whole purpose of the section might be frustrated."[223] Purpose was sufficient to override all objections to judicial activism. The *Borak* Court saw itself as an active partner with the SEC and Congress in achieving the aims of the securities laws, with or without a textual basis for creating a cause of action. No Justice dissented; indeed, Douglas's notes from conference do not indicate any Justice even questioning the propriety of a court implying a private cause of action.[224]

C. Defining the Elements: Reliance, Materiality, and Scienter

With the Supreme Court validating judicially implied private causes of action under the securities laws in *Borak*, the Second Circuit was required to define its elements. The judges of that court battled, with some working to encourage securities fraud class actions by any means possible while a rear guard, led by Friendly, resisted expansion. In *Colonial Realty Corp. v. Bache & Co.*, for example, Friendly declined to imply a cause of action for damages for rules adopted by the exchanges.[225] Friendly, writing for the court, held that "so disruptive" an introduction would "require much more impressive evidence of congressional purpose."[226] Writing to his colleagues, Friendly distinguished *Borak*, advising "[e]ven one so generally favorable to implication of federal claims as I am must stop somewhere."[227] The principal struggle over implied private causes of action would turn on how to interpret the traditional elements of common-law fraud in defining these newly found claims.

Reliance posed a particular problem for certifying a class action because the traditional understanding of reliance would have required individualized proof that the plaintiff had read or heard the misstatement. The Second Circuit did not reject reliance altogether, which would have made certifying a class a simple matter. Instead, in *List v. Fashion Park, Inc.*, the panel held that

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223 *Id.* at 434–35.

224 Justice William O. Douglas Conference Notes in J.I Case Co. v. Borak (Apr. 24, 1964) (on file with William O. Douglas Collection, Library of Congress, Box 1305, Case No. 402). White apparently had some doubts about the sweeping scope of the opinion's reasoning upon reading Clark's first circulation in the case: "Simply too broad a proposition. All reg. stats don't give private [right] of action w[ith] all necessary remedies." Justice Byron White Notes in J.I. Case Co. v. Borak (May 28, 1964) (on file with Byron White Collection, Library of Congress, Box 1:48, Case No. 402)). But, there is no evidence that he communicated his concerns to Clark.

225 Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181 (2d Cir. 1966).

226 *Id.* at 182.

227 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Nov. 9, 1965) (on file with Henry Friendly Collection, Harvard Law School Library, Box 65, Folder 21).

reliance was an element of the Rule 10b-5 cause of action, even in cases of nondisclosure, albeit in a somewhat attenuated fashion.[228] The *List* court rejected a requirement of actual reliance on a silent defendant but held that the trial court was not clearly erroneous in finding that the seller of the stock would have sold even if he had known the identity of the counterparty to his trade.[229]

A bolder approach soon manifested itself in the Second Circuit's decision in *Green v. Wolf Corp.*, applying the recently revised Rule 23 of the Federal Rules of Civil Procedure.[230] Addressing the class certification question, Kaufman, writing for the court, was "not unmindful of the importance of 10b-5 class actions as a weapon against securities fraud and the wisdom of avoiding over-rigidity in blocking such suits."[231] With those purposes in mind, Kaufman rejected the defendant's argument that individual questions of reliance would predominate over questions common to the class:

> Carried to its logical end, it would negate any attempted class action under Rule 10b-5, since . . . reliance is an issue lurking in every 10b-5 action. We see no sound reason why the trial court, if it determines individual reliance is an essential element of the proof, cannot order separate trials on that particular issue . . . if necessary.[232]

This holding came in a case with 2200 class members,[233] presenting a daunting task for the beleaguered district judge charged with conducting those separate trials.

The *Green* court did show restraint in another respect, however, by rejecting the plaintiff's punitive damages claim. Its rationale sheds light on the court's role in implying causes of action:

> [W]hen the 1934 Act was passed, it was not envisioned that it would provide the basis for so many private actions. Indeed, until J.I. Case v. Borak . . . no one was sure that private actions could flow from violations of the securities acts. [Plaintiff]'s argument that since a cause of action here is only implied, the cause of action should have all the attributes of common law fraud is unfounded. We have gone far beyond the limits of the common law in imposing liability under 10b-5 and thus may not import all the other aspects of common law fraud without scrutiny.[234]

"Scrutiny" implied that the court would be deciding which elements of common-law fraud served the policy objectives of the Exchange Act. From that starting point, the court concluded that punitive damages were unnecessary to promote deterrence because defendants were already "subject to crushing liabilities simply on the basis of actual damages because of the cumulative

228 List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965).
229 *Id.* at 463–64.
230 Green v. Wolf Corp., 406 F.2d 291, 298 (2d Cir. 1968).
231 *Id.* at 299.
232 *Id.* at 301 (citation omitted).
233 *Id.*
234 *Id.* at 303 (citation omitted).

injury that a misstatement concerning widely held stock can cause."[235] By this point, the Second Circuit was engaged in unapologetic policy analysis, with the text of the Exchange Act fading into the background.

Six years passed after *J.I. Case* before the Supreme Court returned to the task of developing private rights of action under the securities laws. The liberal warriors, Chief Justice Earl Warren and Justice Arthur Goldberg, were now gone, with Chief Justice Warren Burger succeeding Warren, but Blackmun was not yet confirmed to replace Goldberg's successor Justice Abe Fortas, whose short tenure on the Court had ended in controversy.[236] These changes in personnel did not alter the approach to the securities laws: *Mills v. Electric Auto-Lite Co.*,[237] another merger case, largely confirms and extends *J.I. Case*, despite being written by the relatively conservative Harlan.[238] The private cause of action under section 14(a) was once again at issue. This time the Court was called upon to define the elements of materiality and causation. The Seventh Circuit had rejected the shareholders' claim on the grounds that the terms of the merger were fair. The Court rejected fairness as a defense: "The risk that [shareholders] would be unable to rebut the corporation's evidence of the fairness of the proposal, and thus to establish their cause of action, would be bound to discourage such shareholders from the private enforcement of the proxy rules that 'provides a necessary supplement to Commission action.'"[239] The Court leaves no doubt that it was committed to promoting private causes of action to further the purposes of the securities laws.

235 *Id.* The court also noted the pocket-shifting element of imposing punitive damages on a corporation "because the heavy burden would ultimately fall on all the stockholders." *Id.*

236 Fortas, who had worked at the SEC and taught securities law at Yale, resigned after it came out that he had been retained as a consultant by the Wolfson Family Foundation while serving on the Supreme Court. *See* LAURA KALMAN, ABE FORTAS: A BIOGRAPHY 51, 365–73 (1990). The Wolfson Family Foundation was established by Louis Wolfson, whose later conviction for violating the Securities Act's registration provisions would be affirmed by the Second Circuit. *See* United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968). Wolfson's petition for writ of certiorari was denied by the Supreme Court, with Fortas recusing himself. Wolfson v. United States, 394 U.S. 946 (1969). Soon thereafter, the extent of Fortas's connection to Wolfson came to light in an article in *Life* magazine. KALMAN, *supra*, at 365. When it did, only Fortas's mentor, Douglas, who had lobbied for his appointment to the Court, discouraged him from resigning. *Id.* at 244, 373. In a somewhat roundabout way, a securities case in which the Supreme Court did not issue a decision ended up having a significant effect on the future direction of the Court, as Fortas's resignation led to Blackmun's eventual appointment. It is worth noting, however, that Goldberg considered Fortas his jurisprudential "clone[ ]," *id.* at 245, so Blackmun, while himself liberal on securities law issues, was unlikely to move securities law in a more liberal direction than Fortas would have if he had remained on the Court.

237 396 U.S. 375 (1970).

238 Harlan had worked as a corporate litigator before his appointment to the Second Circuit. *See* TINSLEY E. YARBROUGH, JOHN MARSHALL HARLAN: GREAT DISSENTER OF THE WARREN COURT 52 (1992).

239 *Mills*, 396 U.S. at 382 (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)).

The causation standard adopted by the Court is generous to shareholders: if a misstatement is found to be material, the plaintiff need only prove "that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction."[240] Causation need not be direct; materiality is the key, and here too the *Mills* Court was inclined to be generous to plaintiffs. The determination of materiality "indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote."[241] The Court suggests that a "significant *propensity* to affect the voting process" would be sufficient.[242] Under this standard, few cases would be dismissed at the early motion stage of the litigation.

The *Mills* Court's plaintiff-friendly approach, based on its reading of statutory purpose, is underscored by the decision's final holding: plaintiffs "who have established a violation of the securities laws by their corporation and its officials, should be reimbursed by the corporation or its survivor for the costs of establishing the violation."[243] This holding provoked (minimal) disagreement among the Justices. Black, who viewed himself as a strict textualist,[244] dissented alone, arguing that the Exchange Act did not authorize an award of attorneys' fees. According to Black, "[t]he courts are interpreters, not creators, of legal rights to recover and if there is a need for recovery of attorneys' fees to effectuate the policies of the Act here involved, that need should in my judgment be met by Congress, not by this Court."[245] The majority readily rebuffed Black's objection that its holding lacked a basis in the statute:

> The Act makes no provision for private recovery for a violation of § 14 (a), other than the declaration of "voidness" in § 29 (b), leaving the courts with the task, faced by this Court in *Borak*, of deciding whether a private right of action should be implied. The courts must similarly determine whether the special circumstances exist that would justify an award of attorneys' fees, including reasonable expenses of litigation other than statutory costs.[246]

The cow had already left the barn; textualism's force as an interpretive constraint had been eviscerated by *Borak*. Having created the private right of action, the Court felt confident relying on its own judgment in defining its elements.

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240 *Id.* at 385.

241 *Id.* at 384.

242 *Id.*

243 *Id.* at 389–90. In this, the Supreme Court was following the Second Circuit's holding in *Smolowe v. Delendo Corp.*, an opinion written by Charles Clark. *Id.* at 390 (citing Smolowe v. Delendo Corp., 136 F.2d 231, 241 (2d Cir. 1943)).

244 *Cf.* Roger K. Newman, Hugo Black: A Biography 288 (2d ed. 1994).

245 *Mills*, 396 U.S. at 397 (Black, J., concurring in part and dissenting in part).

246 *Id.* at 391 (majority opinion).

We saw *Affiliated Ute Citizens of Utah v. United States*[247] earlier in connection with insider trading, but that case's principal significance flows from its holding on the element of reliance under Rule 10b-5. *Mills* had focused on causation more broadly, discounting the importance of reliance in the context of Rule 14a-9,[248] but the lower court decisions in *Affiliated Ute* squarely presented the issue. The Court concluded in *Affiliated Ute* that positive proof of reliance is not a prerequisite to recovery under Rule 10b-5 in a case of omission; instead, it looked to *Mills* and its broad conception of causation for the necessary connection between defendant's wrongful conduct and plaintiff's harm: "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important . . . ."[249] Materiality, as an objective standard, was amenable to proof on a classwide basis, whereas individual reliance was not. Thus, *Affiliated Ute* opened the door for the modern securities class action. In his cover memorandum to his colleagues accompanying his draft of the opinion, Blackmun conceded: "I have taken a very liberal approach to Rule 10b-5. This may represent a step beyond any point the Court has heretofore reached. This undoubtedly is the most important aspect of the case and I urge your close attention to it."[250] The Court was unanimous, albeit shorthanded, on the reliance point; Powell and Rehnquist had joined the Court after oral argument and did not participate in the decision.

Given the volume of securities cases in the Second Circuit, it was inevitable that the appellate court would have to grapple with the definition of materiality, an issue common to virtually all securities litigation. *List*, discussed above in relation to reliance, touched upon the element of materiality, citing Louis Loss for the proposition that materiality under Rule 10b-5 "is ostensibly the same as at common law."[251] Fleshing out that standard, *List* also cited a Seventh Circuit case holding that materiality includes "facts 'which in reasonable and objective contemplation might affect the value of the corporation's stock or securities.'"[252] The "might" in this formulation would prove too sweeping, even for the Second Circuit, despite finding its way in to the Supreme Court's opinion in *Mills*.[253] Five years later, in *Gerstle v. Gamble-Skogmo, Inc.*, Friendly would hold that "might" was "too low a thresh-

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247 406 U.S. 128 (1972).

248 *Mills*, 396 U.S. at 382 n.5 ("Proof of actual reliance by thousands of individuals would . . . not be feasible, and reliance on the *nondisclosure* of a fact is a particularly difficult matter to define or prove." (citation omitted)).

249 *Affiliated Ute*, 406 U.S. at 153–54. The Court also cited a Second Circuit case for the proposition that causation in fact would suffice to show reliance in a case of nondisclosure. *Id.* at 153 (citing Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970).

250 Memorandum from Harry A. Blackmun, Assoc. Justice, Supreme Court of U.S., to Conference (April 10, 1972) (on file with Thurgood Marshall Collection, Library of Congress, Box 84).

251 List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

252 *Id.* (quoting Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963)).

253 *Mills*, 396 U.S. at 384.

old" "suggestive of mere possibility, however unlikely."[254] He instead endorsed a "would" standard, justifying the constraint by the "heavy damages that may be imposed."[255] Friendly's more stringent formulation would be adopted by the Supreme Court three years later.[256]

Materiality was another area in which *Texas Gulf Sulphur* broke new ground.[257] Waterman, who wrote the opinion in *List*, wrote for the majority of the in banc court in *Texas Gulf Sulphur*. After citing his formulation from *List*, Waterman expanded the notion of materiality to include forward-looking information:

> The speculators and chartists of Wall and Bay Streets are also "reasonable" investors entitled to the same legal protection afforded conservative traders. Thus, material facts include . . . those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.[258]

Having included forward-looking information in the definition—surely welcome news to professional investors—Waterman set a standard for assessing its materiality that would become quite influential: "[W]hether facts are material . . . will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[259] The Supreme Court, in an opinion written by Blackmun, would adopt this "probability/magnitude" standard two decades later.[260]

Of equal importance to materiality in securities litigation is the question of state of mind. The Supreme Court did not enter into this discussion in the 1960s, but the Second Circuit grappled with the topic repeatedly, setting the stage for the Supreme Court's intervention in the 1970s. Once again, the *Texas Gulf Sulphur* decision marked a critical point in Rule 10b-5 jurisprudence. The in banc majority held that negligence was sufficient in a case in which the SEC was seeking injunctive relief because "the investing public is hurt by exposure to false or deceptive statements irrespective of the purpose underlying their issuance."[261] Judge Robert Anderson expressed "serious reservations" about the holding, framing the now familiar policy dilemma: "The potential deterrent effect of the majority's 'due diligence' standard runs directly counter to the policy of the Act and the practice in the industry to encourage the dissemination of important information by the corpora-

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254 Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973).

255 *Id.*

256 *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 445–46 (1976).

257 SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (in banc).

258 *Id.* at 849 (footnote omitted).

259 *Id.*

260 *See* Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988).

261 *Texas Gulf Sulphur*, 401 F.2d at 861. We address the implications of *Texas Gulf Sulphur* for corporations' liability for misstatements at somewhat greater length in A.C. Pritchard & Robert B. Thompson, Texas Gulf Sulphur *and the Genesis of Corporate Liability Under Rule 10b-5*, 71 SMU L. Rev. 927 (2018).

tion."[262] In other words, too low of a standard risks chilling voluntary corporate disclosures. The majority, however, was more concerned that too high a standard might leave even some intentional fraud undeterred, given the evidentiary difficulties posed in proving state of mind.

Friendly, too, was frightened by the implications of the majority's holding for private rights of action. He had written to Louis Loss, requesting the relevant pages from Loss's forthcoming revision of his treatise "dealing with the remedial aspects of Rule 10b-5 as applied to private litigation, since I do not think we could deal intelligently with the instant case without considering its effect in that field."[263] Friendly warned his colleagues that the corporation's liability for its press release downplaying the potential mineral find was

> the most important issue in the case. If there were any way to limit the holding to injunctive relief or even to actions brought by the SEC, the dangers inherent in the opinion of the panel majority would not be anything like so great. . . . [T]the financial consequences of holding corporations liable for innocent errors or omissions in press releases, all judged on a basis of hindsight, are incalculable. We kid ourselves when we talk of liability of 'the corporation'; the rule announced by the majority would cause thousands of innocent investors like ourselves, who buy stocks and put them away, to be mulcted for the benefit of tapewatchers and more particularly, of Pomerantz & Co.[264]

Friendly did not believe that the majority's holding could be limited to suits brought by the SEC: "I see no basis for making that distinction" even if it might be defended "as a policy matter."[265] Here was a sharp divide among the Second Circuit judges—the latitude they were willing to find within a statute's text. Only two of Friendly's colleagues joined his sharp concurrence.[266] In another in banc case handed down later that year, Friendly grudgingly applied the negligence standard in another SEC enforcement action alleging violations of Rule 10b-5.[267] When the issue presented itself in a private lawsuit, however, a majority of the in banc Second Circuit held "that proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5,"[268] limiting the holding in *Texas Gulf Sulphur* to

262 Memorandum from Robert P. Anderson, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges 5 (May 27, 1968) (on file with Henry Friendly Collection, Harvard Law School Library, Box 135, Folder 5).

263 Letter from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Louis Loss, Professor of Law, Harvard Univ. (May 27, 1968) (on file with Henry Friendly Collection, Harvard Law School Library, Box 135, Folder 5).

264 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges 3–4 (May 8, 1968) (on file with Henry Friendly Collection, Harvard Law School Library, Box 135, Folder 5). "Pomerantz & Co." referred to the plaintiffs-side law firm.

265 *Id.* at 7.

266 *Texas Gulf Sulphur*, 401 F.2d at 864–69 (Friendly, J., concurring).

267 *See* SEC v. Great Am. Indus., Inc., 407 F.2d 453, 478 (2d Cir. 1968) (in banc).

268 Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc).

suits by the SEC for injunctive relief.[269] Friendly's difficulties in *Texas Gulf Sulphur* in finding a basis for that distinction in the statute were overlooked, as were the objections of four dissenting judges.[270]

When the question of state of mind arose again under Rule 14a-9, however, the Second Circuit came down on the side of negligence.[271] Somewhat surprisingly, Friendly authored the opinion, having raised the issue at oral argument.[272] Friendly leaned heavily on the textual differences between section 10(b) and section 14(a), emphasizing the broader rulemaking authority afforded the SEC by the latter.[273] Friendly also looked to the structure of the Exchange Act:

> [W]hile an open-ended reading of Rule 10b-5 would render the express civil liability provisions of the securities acts largely superfluous, and be inconsistent with the limitations Congress built into these sections, a reading of Rule 14a-9 as imposing liability without scienter in a case like the present is completely compatible with the statutory scheme.[274]

Friendly used traditional tools of statutory construction—text and structure—rather than purpose, in coming to a plaintiff-friendly result.[275] The Supreme Court would soon begin to wield those interpretive tools in the opposite direction to cabin the reach of the securities laws.

D. Pruning the Judicial Oak: Rule 10b-5 Restrained

The expansion of private rights of action came to an abrupt halt in the 1970s. The first salvo came in a pair of class actions from the mid-1970s—*Blue Chip Stamps v. Manor Drug Stores*[276] and *Ernst & Ernst v. Hochfelder*[277]—in which the Supreme Court made plain its intention to rein in Rule 10b-5. *Blue Chip Stamps* affirmed the Second Circuit's *Birnbaum* rule—questioned since its adoption in 1952—requiring a purchase or sale of securities to state a private claim under Rule 10b-5.[278] The opinion is also notable for its skepticism regarding securities fraud class actions under Rule 10b-5—"a judicial oak which has grown from little more than a legislative acorn"—the vehicle

269 *See id.* at 1305.

270 *Id.* at 1311 (Hays, J., concurring in part and dissenting in part). Judges Smith, Oakes, and Timbers joined Judge Hays's opinion. *Id.*

271 *See* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300–01 (2d Cir. 1973).

272 *See* Letter from Emanuel Becker, Attorney, Becker Schreiber & Gordon, to Henry J. Friendly, James L. Oakes, & Oscar H. Davis, Judges, U.S. Court of Appeals for the Second Circuit (Feb. 21, 1973) (on file with Henry Friendly Collection, Harvard Law School Library, Box 65, Folder 1).

273 *See Gerstle*, 478 F.2d at 1299.

274 *Id.* (citations omitted).

275 Louis Loss, in his memoriam after Friendly's death, noted that *Gerstle v. Gamble-Skogmo, Inc.* was Friendly's "favorite" securities opinion and "quite understandably." Loss, *supra* note 29, at 1723.

276 421 U.S. 723 (1975).

277 425 U.S. 185 (1976).

278 *Blue Chip Stamps*, 421 U.S. at 731–32, 749.

through which the Second Circuit had pushed the boundaries of Rule 10b-5 throughout the 1960s and early 1970s.[279]

Ernst & Ernst, a Powell opinion, signals a reading of Rule 10b-5 narrowly tethered to the text of section 10(b). In rejecting the argument that an allegation of negligence would establish a fraud claim under Rule 10b-5 (which had been accepted by the Second Circuit in *Texas Gulf Sulphur*), the Court emphasized that the scope of Rule 10b-5 "cannot exceed the power granted the [SEC] by Congress under section 10(b)."[280] In other words, the SEC would be constrained going forward by the Court's power over statutory interpretation. *Blue Chip Stamps* and *Ernst & Ernst* signaled that the Supreme Court had abandoned "flexible" construction of the sort seen in *Cady, Roberts*, and *Capital Gains* to achieve "remedial purposes."[281]

Powell would have gone further, rolling back the whole business of implying private rights of action. He fired the first shot in *Cannon v. University of Chicago*,[282] involving the question of the implication of a private right of action under Title IX, which prohibits sex discrimination by universities receiving federal aid.[283] Powell dissented from the Court's recognition of a private cause of action, arguing that "[w]hen Congress chooses not to provide a private civil remedy, federal courts should not assume the legislative role of creating such a remedy and thereby enlarge their jurisdiction."[284] *J.I. Case Co. v. Borak*[285] was singled out for special scorn, as a

> decision both unprecedented and incomprehensible as a matter of public policy. The decision's rationale, which lies ultimately in the judgment that "[p]rivate enforcement of the proxy rules provides a necessary supplement to Commission action," ignores the fact that Congress, in determining the degree of regulation to be imposed on companies covered by the Securities Exchange Act, already had decided that private enforcement was unnecessary. More significant for present purposes, however, is the fact that *Borak*, rather than signaling the start of a trend in this Court, constitutes a singular and, I believe, aberrant interpretation of a federal regulatory statute.[286]

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279 *See* id. at 739, 741 (noting that "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general" and the risk that the threat of enormous discovery costs could produce "*in terrorem*" settlements).

280 *Ernst & Ernst*, 425 U.S. at 214.

281 The Court went further still in *Aaron v. SEC*, 446 U.S. 680 (1980), holding that the SEC was also required to prove scienter in an action seeking injunctive relief, thus brushing aside the distinction the Second Circuit had drawn. Friendly's inability to draw a textual distinction between private and public litigants, see *supra* notes 264–65 and accompanying text, proved dispositive.

282 441 U.S. 677 (1979).

283 *Id.* at 681–83.

284 *Id.* at 730–31 (Powell, J., dissenting).

285 377 U.S. 426 (1964).

286 *Cannon*, 441 U.S. at 735–36 (Powell, J., dissenting) (footnote and citation omitted) (quoting *J.I. Case Co.*, 377 U.S. at 432).

Powell continued in a footnote, "[a]lthough I do not suggest that we should consider overruling *Borak* at this late date, the lack of precedential support for this decision militates strongly against its extension beyond the facts of the case."[287] The recognition of private rights of action during the 1960s had fueled the expansion of the securities laws; Powell stood ready to limit the damage. The Court soon incorporated Powell's view in a holding which preserved *Borak* but limited any further implied actions under the securities laws.[288]

Two terms later in *Herman & MacLean v. Huddleston*[289] the Court squarely faced the mechanism responsible for that expansion: the implied private right of action under Rule 10b-5,[290] which Douglas had addressed only in passing in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[291] The question logically preceded the question of whether section 10(b) afforded a private cause of action for conduct that would be actionable under the explicit private cause of action provided by section 11 of the Securities Act.[292] Although Powell was "tempted" to vote that there was no private cause of action under section 10(b), he pulled back from repudiating a cause of action that went back more than thirty years.[293] Having conceded the existence of the private right of action under section 10(b), Powell saw no defensible basis for carving out exceptions when the securities laws expressly provided causes of action.[294] Marshall's unanimous opinion for the Court described the private Rule 10b-5 claim's existence as "beyond peradventure."[295]

The survival of the Rule 10b-5 private cause of action left the door open for a Supreme Court decision that hearkened back to the activist days of the Sixties, *Basic, Inc. v. Levinson*.[296] Powell had recently retired when *Basic* was argued. His departure left a void, and Blackmun stepped in to write the *Basic*

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287 *Id.* at 735–36 n.6 (citation omitted).

288 Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979).

289 459 U.S. 375 (1983).

290 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

291 *Herman & MacLean*, 459 U.S. at 379. The statute of limitations had run on the plaintiffs' section 11 claim at the time they filed suit, so it was Rule 10b-5 or nothing. *See* Preliminary Memorandum from Unknown Author to Lewis F. Powell, Jr., Assoc. Justice, Supreme Court of U.S. 6 (Feb. 19, 1982).

292 15 U.S.C. § 77k(a) (2012).

293 *See* Bench Memorandum from Jim Browning, Law Clerk, Supreme Court of U.S., to Lewis F. Powell, Jr., Assoc. Justice, Supreme Court of U.S. 20 (Sept. 9, 1982) (on file with Lewis F. Powell, Jr. Collection, Washington & Lee University).

294 *See id.* at 1, 11 (stating that the all-inclusive language made it difficult to carve out exceptions).

295 *Herman & MacLean*, 459 U.S. at 380. By the time the Court met in conference to decide the case, Powell had recused himself, having learned that his son-in-law's investment banking firm was a defendant in a similar case. *See* Letter from Lewis F. Powell, Jr., Assoc. Justice, Supreme Court of U.S., to Warren Burger, Chief Justice, Supreme Court of U.S. (Nov. 11, 1982) (on file with Lewis F. Powell, Jr. Collection, Washington & Lee University).

296 485 U.S. 224 (1988).

opinion for a 4–2 majority. Blackmun built on his work from *Affiliated Ute*, decided just before Powell and Rehnquist joined the Court, which had excused reliance in cases involving omissions.[297] *Affiliated Ute* had been the previous high watermark for the implied cause of action under Rule 10b-5 and the last salvo of the purposive period. *Basic* was a return to that old-time religion, opening the doors wide to securities fraud class actions under Rule 10b-5 by creating a presumption of reliance for misrepresentations affecting securities traded in the secondary public markets—the fraud on the market theory ("FOTM").[298] The FOTM presumption avoids the evidentiary difficulties of showing actual reliance in cases with affirmative statements, and as a byproduct, greatly expands the size of the class, and thus, the potential amount of damages.[299] Although courts are no longer discovering new private rights of action under the securities laws, Rule 10b-5 survives. Those claims, bolstered by the FOTM presumption, continue to provide a strong and persistent federal presence in corporate law.

III. Rule 10b-5 and Corporate Mismanagement

The impetus to develop Rule 10b-5 and its implied cause of action was driven in part by perceived failures in state law. As Louis Loss explained in remarks to an ABA conference in 1966 on the proposed codification of the federal securities laws: "Like many people in this room, if not all of us, I am convinced that basically what we have from 10b-5 was overdue. . . . The common law was strangely laggard in appreciating the fiduciary obligations of directors and other insiders to shareholders."[300]

The Second Circuit's 1952 decision in *Birnbaum v. Newport Steel Corp.* appeared to hobble the use of 10b-5 to expand fiduciary duty.[301] Subsequent Second Circuit decisions during the 1960s, however, pushed the boundaries of Rule 10b-5 to cover mismanagement traditionally governed by state law. The Supreme Court's 1971 decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.* embraced a broad reach of the Rule. As with its earlier decisions of this era, the Supreme Court's *Bankers Life* decision led to more Second Circuit opinions reading the Exchange Act broadly to give effect to

297 Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).

298 *Basic Inc.*, 485 U.S. at 241.

299 If each member of the plaintiff class were required to allege that they had read and relied on the misstatement in making their decision to purchase, it would defeat the commonality requirement for class actions. *See* Fed. R. Civ. P. 23(b)(3) (class action maintainable if "the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members."). The FOTM presumption allows plaintiffs to skip the step of alleging personal reliance on the misstatement, instead allowing them to allege that the *market* relied on the misrepresentation in valuing the security. The plaintiffs in turn are deemed to have relied upon the distorted price produced by a deceived market.

300 Freeman, *supra* note 30, at 918 (including remarks by Louis Loss). Learned Hand had expressed a similar view a decade before. *See supra* note 53 and accompanying text.

301 Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952).

its purpose. Soon thereafter, however, the Supreme Court would reverse course, more dramatically than it did in the fields of insider trading and implied rights of action.

A. *The Second Circuit Tackles Corporate Mismanagement*

Judges recognizing private rights of action under the SEC's antifraud rules of 10b-5 and 14a-9 were frequently motivated by a critical view of prevailing state corporate law and its enforcement; federal law was needed to reinforce fiduciary responsibilities. In a memorandum to his *Birnbaum* colleagues, Learned Hand endorsed a broad view of fraud under federal law, untethered from misstatements:

> Although it goes a little against my grain to say so, I think we should say that for a shareholder, who has control of a company, to use his power against the other shareholders to their detriment, is a "fraud" upon them. The word is very loosely used, and covers other wrongs than those covered by reliance on false utterances. The sale of Feldman's shares . . . would therefore be a "fraud" which "operated" on the Newport Co., and all that remained would be whether the "act" "operated" "in connection with the . . . sale."[302]

Despite his broad view of the definition of fraud, Hand felt the SEC's press release describing its adoption of Rule 10b-5 limited its reach to protecting purchasers in a securities transaction.[303] For Hand at least, traditional materials of interpretation were a constraint on unmoored understandings of purpose. More pragmatically, Swan's contemporaneous memorandum expressed worry that plaintiffs would seek to make every breach of an officer's fiduciary duty a violation of the securities laws "because otherwise not all wrongdoers can be reached in a single suit. Such a construction would be likely to flood the federal courts with litigation of this character."[304] Swan's opinion for the panel emphasized the Rule's (and the Act's) focus on purchasers or sellers defrauded in their transaction rather than fraud in the mismanagement of corporate affairs.[305] This distinction between fraud and

302 Memorandum from Learned Hand, Judge, U.S. Court of Appeals for the Second Circuit, to Augustus Hand & Thomas Swan, Judges, U.S. Court of Appeals for the Second Circuit 1–2 (Dec. 14, 1951) (on file with Learned Hand Collection, Harvard Law School Library, Box 213, Folder 21) [hereinafter Memorandum from Learned Hand] (second alternation in original); *see also supra* note 53 and accompanying text.

303 Memorandum from Learned Hand, *supra* note 302, at 2. Hand referred to the press release announcing promulgation of the rule in which the SEC emphasized that the rule closed a gap so that deceptive purchasers would be covered as well as deceptive sellers, who were already covered by section 17(a) of the Securities Act.

304 Memorandum from Thomas Swan, Judge, U.S. Court of Appeals for the Second Circuit, to Augustus Hand & Learned Hand, Judges, U.S. Court of Appeals for the Second Circuit 2 (Dec. 15, 1951) (on file with Learned Hand Collection, Harvard Law School Library, Box 213, Folder 21).

305 *See Birnbaum*, 193 F.2d at 464.

mismanagement would become a long-running battleground in Rule 10b-5 jurisprudence.

The Second Circuit did its part to bolster the state corporate law of fiduciary duty in diversity cases. *Perlman v. Feldmann* arose from the same transaction as *Birnbaum v. Newport Steel*: the controlling shareholder's taking a control premium for sale of the business instead of sharing it with all shareholders.[306] Clark, writing for himself and Frank, found a violation of fiduciary duty, invoking then-Judge Benjamin Cardozo's famous "punctilio of an honor the most sensitive" as the standard of fiduciary behavior and "[u]ncompromising rigidity" as the attitude of the courts.[307] The majority noted that it did "not mean to suggest that a majority stockholder cannot dispose of his controlling block of stock to outsiders without having to account to his corporation for profits."[308] Indeed, a string of cases in Delaware, the Second Circuit, and elsewhere, has permitted such a taking.[309] But *Perlman* remains the most demanding articulation of fiduciary duty in this space.[310]

B. Mismanagement Cases Under Rule 10b-5

In holding that Rule 10b-5 protected defrauded sellers as well as purchasers of securities, the Second Circuit in *Birnbaum* also delineated who was not covered—those harmed by mismanagement of corporate affairs.[311] Left unclear was the Rule's coverage of conduct that included both fraud in the purchase or sale of securities and corporate mismanagement. A pair of Second Circuit cases decided contemporaneously in December 1964, both in the wake of *Borak* and *Capital Gains*, framed the issue.

In *Ruckle v. Roto American Corp.*,[312] a panel of Medina, Lumbard, and Marshall (concurring in the result) permitted Rule 10b-5 to be used when a corporation had issued its own shares to its president who controlled a majority of the board. The court found the minority shareholder had been

306 Perlman v. Feldmann, 219 F.2d 173, 174 (2d Cir. 1955).

307 *Id.* at 176 (quoting Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928)).

308 *Id.* at 178.

309 *See* Mendel v. Carroll, 651 A.2d 297, 305 (Del. Ch. 1994) ("The law has acknowledged, albeit in a guarded and complex way, the legitimacy of the acceptance by controlling shareholders of a control premium.").

310 Interestingly, the opinion omits what might be the most compelling fact for finding breach of duty: Feldman, the controlling shareholder, had, as an officer of the corporation, rejected a merger offer from a competing bidder that would have permitted all the shareholders to share in the gain for the sale of the company's business, not just the controlling shareholder. When the takeover wars of the 1980s reached the courts, such a fact would be treated as critical. This fact was noted in the *Birnbaum* decision. *Birnbaum*, 193 F. 2d at 462. Swan was the only member of the *Perlman* panel to also sit on the *Birnbaum* case decided three years earlier; he dissented in *Perlman* without discussing this fact that had appeared in his *Birnbaum* opinion.

311 *Id.* at 464.

312 339 F.2d 24 (2d Cir. 1964).

deceived.[313] *Birnbaum* and *O'Neill v. Maytag*[314] (issued later that month) were distinguished as situations in which the corporation had not been deceived.[315] In *O'Neill*, a panel with two of the same judges (Lumbard and Marshall) declined to apply Rule 10b-5 to an exchange between an airline and its twenty-one percent shareholder.[316] The panel, over a dissent by Hays, distinguished state law duties for which deception may be immaterial to their breach. Rejecting the arguments of the SEC, the *O'Neill* panel held it not sufficient.

> [T]o allege a breach of one of these general fiduciary duties where the breach does not involve deception. . . . [D]eception may be immaterial to a breach of duties imposed under common law principles. . . . There may be difficulties in drawing this line . . . [b]ut these difficulties do not justify our treating this section, or the rule, as a mandate to inquire into every allegation of breach of fiduciary duty relating to the issuance or sale of corporate securities.[317]

The *O'Neill* panel distinguished *Ruckle* on the grounds that the defendant controlled a majority of the board and plaintiffs had clearly alleged deception.[318]

This divide was more starkly presented four years later in *Schoenbaum v. Firstbrook*, decided by a panel consisting of three of the four judges who decided *Ruckle* and *O'Neill*.[319] A majority of Lumbard and Medina, over Hays's dissent, declined to apply Rule 10b-5 to a corporation's issuance of shares to a controlling shareholder who knew of an undisclosed oil discovery by the corporation (thus taking the *O'Neill* side of the debate).[320] The circuit en banc then reversed the panel, split roughly along the same lines as *Texas Gulf Sulphur*, decided a few months earlier. The majority en banc opinion, written by Hays, cited *Subin* for the proposition that summary judgment should not be granted in a derivative suit without giving the plaintiff an opportunity for discovery and to cross-examine the company witnesses.[321] Medina in dissent (joined by Lumbard and Moore) echoed Swan's *Birnbaum* concern about "transform[ing] a simple cause of action against directors for waste or the use of bad judgment in the sale of corporate assets into a federal securities fraud case by judicial fiat."[322] It was against the background of these cases that the Second Circuit decided *Bankers Life*, which would make its way to the Supreme Court shortly thereafter.

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313 *Id.* at 28, 29.
314 339 F.2d 764 (2d Cir. 1964).
315 *Id.* at 28.
316 *Id.*
317 *Id.* at 767–68.
318 *Id.*
319 Schoenbaum v. Firstbrook, 405 F.2d 200, 217 (2d Cir. 1968). Marshall had departed to be Solicitor General and then on to the Supreme Court.
320 *Id.* at 211; *see also id.* at 214 (Hays, J., dissenting in part).
321 Schoenbaum v. Firstbrook, 405 F.2d 215, 218 (2d Cir. 1968) (citing Subin v. Goldsmith, 224 F.2d 753 (2d Cir. 1955)).
322 *Id.* at 220 (Medina, J., dissenting in part).

C. *The Apogee of Rule 10b-5 and Corporate Mismanagement:* Bankers Life

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, a corporation sold securities, resulting in an enormous loss.[323] The facts suggested egregious misconduct by those in control of the corporation, but the connection between the sale and the misconduct was attenuated. Insiders in an insurance company had seemingly sold control of the corporation to a purchaser through a complex series of transactions. The proceeds from the company's sale of bonds in a market transaction at a fair price were then shuffled around in a way that permitted those proceeds to be used as payment for the shares conferring control. That is to say, the corporation's assets had been removed from the corporate treasury to pay the purchase price for the control block with no offsetting payment to the corporation. The panel decision found no Rule 10b-5 cause of action.[324] A dissent by Hays tracked his opinion for the in banc circuit in *Schoenbaum* from eighteen months before. He now added a half dozen other Second Circuit cases, including *Texas Gulf Sulphur*, to bolster his argument for Rule 10b-5's expansive scope: "This court has repeatedly indicated its intention to give a broad and liberal interpretation to Rule 10b-5 in order to assure that that provision is used to accomplish the beneficent purposes for which the statutes governing sales of securities were enacted."[325]

The Second Circuit did not rehear the case in banc, but the Supreme Court granted certiorari.[326] The case was argued in the second week of the October Term 1971 and a decision was announced just over three weeks later. Douglas wrote the unanimous opinion, vintage Douglas, the last hurrah of broad securities interpretations before the arrival of Powell and Rehnquist at the turn of the year to replace the recently departed Black and Harlan. The question of whether there was an implied private cause of action under Rule 10b-5 was now addressed by the Court, almost twenty-five years after lower courts first recognized one.[327] The Court validated their conclusion in a footnote inserted in the middle of a quotation from an appel-

323 Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 7–9 (1971) (describing the facts of the case).

324 Superintendent of Ins. v. Bankers Life & Cas. Co., 430 F.2d 355, 361 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971). The decision was written by District Judge M. Joseph Blumenfeld sitting by designation and joined by Lumbard.

325 *Id.* at 362 (Hays, J., dissenting) (citing Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969)); SEC v. Great Am. Indus., Inc., 407 F.2d 453 (2d Cir. 1968) (in banc); SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (in banc); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967); Ruckle v. Roto Am. Corp, 339 F.2d 24 (2d Cir. 1964).

326 *Bankers Life & Cas. Co.*, 404 U.S. at 6.

327 In *Black v. Amen*, 355 U.S. 600 (1958) (per curiam), the Court was prepared to remand to the lower court to consider if Rule 10b-5 carries with it a private cause of action, see Letter from Felix Frankfurter, Assoc. Justice, Supreme Court of U.S., to Earl Warren, Chief Justice, Supreme Court of U.S. (Nov. 20, 1957) (on file with Felix Frankfurter Collection, Harvard Law School, Part 3, Reel 4), but the case settled before the Court's order was issued.

late court opinion. The logic of *Borak* had surely taken much of the suspense out of the question (and Douglas did cite *Borak*); the circuit courts were by then almost unanimous in implying a cause of action. Douglas saw little need to belabor the details of a then-uncontroversial proposition.[328]

The question of remedies for corporate mismanagement under the antifraud statute was dispatched briefly, with none of the struggle witnessed in the Second Circuit over the prior decade. That the fraud was perpetrated by officers of the insurance company and their outside collaborators was "irrelevant" given the loss incurred by the company due to the wrongful conduct and the Congressional purpose that "'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like."[329]

Douglas accepted the part of *Birnbaum*'s holding that did not endanger the cause of action (that there is a purchase or sale of a security, here by the corporation), while ignoring the part of *Birnbaum* that excludes the federal securities laws from being used to remedy corporate mismanagement, all without mentioning *Birnbaum*.[330] Here the insurance company's sale of bonds in a market transaction provided the company a price that was not questioned in the litigation; the sale brought cash into the corporate coffers that duplicitous employees then purloined. Douglas's reasoning is straight out of *Capital Gains*: section 10 (b) must be read "flexibly," "not technically and restrictively."[331] Douglas did not, however, bother to cite that opinion.

The Supreme Court's opinion immediately affected Second Circuit consideration of cases with similar issues, but the lower court did not abruptly change course. At the time that the Supreme Court announced *Bankers Life*, the Second Circuit judges were deciding whether to hear in banc a panel decision in *Drachman v. Harvey* that had found no Rule 10b-5 claim in a corporate mismanagement case.[332] Harvey, a forty percent shareholder, had sold his block of shares to Martin Marietta and then caused the corporation to redeem debentures that could have impeded Martin Marietta's acquiring control, all at a time when Harvey had risk exposure from borrowing at record high interest rates.[333] The panel (Lumbard and Moore, with a dis-

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328 *Bankers Life & Cas. Co.*, 404 U.S. at 13 n.9.

329 *Id.* at 10–12 (quoting H.R. Rep. No. 73-1383, at 6 (1934)).

330 *Id.* at 12 ("We agree that Congress by § 10(b) did not seek to regulate transactions that constitute no more than internal corporate mismanagement."). Blackmun was willing to go farther and overrule *Birnbaum* completely. Justice Harry A. Blackmun Notes in Superintendent of Ins. v. Bankers Life & Cas. Co. 2 (Oct. 12, 1971) (on file with Harry Blackmun Collection, Library of Congress, Box 311) ("[M]y inclination is at odds with that of the Second Circuit. I would also expect to conclude, if we get that far, that the Birnbaum rule, which Learned Hand evolved some time ago, restricting relief under these statutes to a purchaser or seller, would have to be overruled. I would be willing to go that far.").

331 *Bankers Life & Cas. Co.*, 404 U.S. at 12.

332 Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1971) *rev'd in banc*, 453 F.2d 736 (2d Cir. 1972).

333 *Id.* at 724–25.

sent by Smith) decided that a Rule 10b-5 claim would not arise based on the Second Circuit's decision in *Bankers Life* (on which Lumbard also sat): *Drachman* was "indistinguishable in any material respect."[334] When the Supreme Court reversed *Bankers Life*, and with a clear majority of the circuit judges for reversal of the panel decision, Friendly, as Chief Judge, suggested that Smith, the dissenter on the panel, write a new opinion in *Drachman.* Friendly's memorandum proffered the advice that Smith not give the Supreme Court's opinion "an importance beyond what I believe the Court intended," suggesting Douglas had "gone to considerable pains not to overrule *Birnbaum.*"[335]

Federal corporate law came into its own during this period. The handful of Supreme Court cases described above—*Capital Gains, Borak, Mills, Affiliated Ute,* and *Bankers Life*[336]—provided its foundation. The Second Circuit, however, was building the edifice; the appellate court contributed more cases than that to the development of this law just in the five months between *Texas Gulf Sulphur* and the end of that year. Looking more broadly, the Second Circuit decided more than two dozen securities cases between *Capital Gains* and the dramatic change of direction that followed the arrival of Powell and Rehnquist. *Texas Gulf Sulphur,* as already discussed, confirmed the suggestion in *Cady, Roberts* that insider's duties would be within the scope of Rule 10b-5, a significant expansion of the reach of federal law into corporate governance. A series of Second Circuit opinions cut back on *Birnbaum* and its limitations on standing to assert the implied cause of action, thereby allowing Rule 10b-5 to serve as the foundation of federal corporate law.[337] Another series of cases, starting with *Ruckle*[338] and *O'Neill*[339] decided shortly after *Capital Gains,* framed an ongoing debate over corporate mismanagement as the subject of federal law. Shortly after *Texas Gulf Sulphur,* the Sec-

334 *Id.* at 733.

335 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to Second Circuit Judges (Nov. 29, 1971) (on file with Henry Friendly Collection, Harvard Law School, Box 136, Folder 20) ("Rather surprisingly in view of the author, the opinion seems to me to have been extremely moderate.").

336 The Court also decided *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), a case involving the SEC, but it had little impact. *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418 (1972), a section 16(b) case discussed above, *supra* notes 172–73 and accompanying text, seems a remnant of the earlier period.

337 *See* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2d Cir. 1969) (noting *Birnbaum* requirement had been interpreted broadly in subsequent cases); SEC v. Great Am. Indus., Inc., 407 F.2d 453, 462 (2d Cir. 1968) (in banc) (overturning a panel decision that denied the SEC a temporary injunction, distinguishing fraudulent practices and corporate mismanagement); A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 n.3 (2d Cir. 1967) (involving plaintiffs who were defrauded by defendants' alleged failure to pay for securities, and plaintiffs could bring a Rule 10b-5 claim); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967) (involving shareholders who, cashed out in a short form merger by controlling shareholders, were forced sellers with standing to bring a Rule 10b-5 claim).

338 Ruckle v. Roto Am. Corp, 339 F.2d 24 (2d Cir. 1964) (involving facts where a majority of directors caused a corporation to improperly issue stock to an insider to perpetuate their own control without disclosure to the entire board).

ond Circuit in *Schoenbaum v. Firstbrook* had come down decisively on the side of federal securities law regulating such corporate mismanagement.[340] A steady flow of commentators described this string of precedent as federal corporate law: SEC Chairman Cary had used the federal corporate law moniker in *Cady, Roberts*.[341] The term "federal corporate law" quickly gained wide use.[342] Rule 10b-5's displacement of state law fiduciary duty had reached its apogee. It was not long to endure, abruptly pushed aside by the change in the Supreme Court in the 1970s.

D. The Demise of Federal Corporate Law

The Second Circuit's efforts to push Rule 10b-5 into the realm of corporate governance were soon rebuffed by the Supreme Court under the influence of Powell. *Santa Fe Industries, Inc. v. Green*[343] is the Court's most sweeping defense of state corporate law. A Second Circuit panel consisting of Medina, Mansfield, and Moore (with Moore dissenting) held that a short form merger authorized by Delaware law,[344] which "froze[ ] out" the company's minority shareholders, violated Rule 10b-5.[345] The appellate court held that "no allegation or proof of misrepresentation or nondisclosure [was] necessary" to state a violation of Rule 10b-5; a breach of fiduciary duty was sufficient.[346] Rule 10b-5 was completely divorced from disclosure, fair-

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339 O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964) (holding that there is no Rule 10b-5 claim for an exchange of stock as part of an internal struggle for control where there is no deception).

340 Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc) (holding that a corporation issuing stock to controlling shareholder is liable for deceiving the shareholders other than the controlling shareholders).

341 *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.10 (1961). Cary's executive assistant at the SEC later developed the idea of federal corporate law in a *Harvard Law Review* article titled *Federal Corporation Law: An Assessment*. Fleischer, *supra* note 5, at 1148 ("It is the thesis of this article that the growth of federal law in the corporate area is sound and consistent with the scope and purposes of the securities laws and that the critics' attacks are misdirected.").

342 *See generally* Stanley A. Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433, 476–77 (1968) ("[T]here has been an extraordinarily rapid burgeoning of so-called 'federal common law of corporations,' based upon implied civil liability under section 10(b) of the Securities Exchange Act of 1934; this law is pervading, and all but absorbing, a large portion of internal fiduciary obligations."); Lewis D. Lowenfels, *The Demise of the* Birnbaum *Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268, 268 (1968) ("[A] vast body of federal corporate common law has mushroomed under [Rule 10b-5]."); Donald E. Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71, 81 (1972) ("Mainly as an interpretation of the SEC's [R]ule 10b-5, courts have created a federal common law of corporations to advance shareholder rights." (footnote omitted)).

343 430 U.S. 462 (1977).

344 DEL. CODE ANN. tit. 8, § 253 (1974).

345 *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1299 (2d Cir. 1976), *rev'd*, 430 U.S. 462 (1977).

346 *Green*, 533 F.2d at 1287.

ness was the touchstone. Moreover, that breach of fiduciary duty arose out of federal, rather than state, common law.[347]

In reversing the Second Circuit, White held for the Court that fraud requires a misrepresentation or nondisclosure, not just overreaching.[348] That was sufficient to answer the question presented, but White went out of his way to defend state corporate law against the incursion of federal securities law:

> The reasoning behind a holding that the complaint in this case alleged fraud under Rule 10b-5 could not be easily contained. . . . The result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. . . . [T]his extension of the federal securities laws would overlap and quite possibly interfere with state corporate law. Federal courts applying a "federal fiduciary principle" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.[349]

The Supreme Court was emphatic in drawing a line in the sand to preserve state corporate law from the Second Circuit's development of its own "federal fiduciary principle."

The dramatic change in the securities jurisprudence of the Supreme Court during the 1970s and continuing through the mid-1980s required the Second Circuit to trim its sails from its activist era. The Second Circuit distinguished prior cases from the new precedent, continued to fill gaps left by the Supreme Court's jurisprudence, and sometimes fell in line with the new direction from above.

Goldberg v. Meridor illustrates attempts to distinguish.[350] The case was argued before a Second Circuit panel of Judges Friendly, Thomas Meskill, and William Timbers (a former general counsel of the SEC) less than three months after the Supreme Court's decision in *Santa Fe*. *Goldberg* presented the question of the continued viability of Rule 10b-5 liability for corporate mismanagement involving a controlling shareholder of the corporation who caused the entity to acquire assets from himself on unfair terms. In contrast to the lower court's enthusiastic embrace of *Capital Gains* in the 1960s, *Santa Fe* was, at best, grudgingly tolerated. As Friendly wrote his colleagues on the *Goldberg* panel:

347 *Id.* at 1286 (citing Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972)).

348 *Santa Fe*, 430 U.S. at 473–74. The Court had said as much in dicta in 1969. *See* SEC v. Nat'l Sec., Inc., 393 U.S. 453, 462–63 (1969) ("Presumably, full disclosure would have avoided the particular Rule 10b-5 violations alleged in the complaint.").

349 *Santa Fe*, 430 U.S. at 478–79 (citation and footnote omitted). Justice Brennan dissented and Justices Blackmun and Stevens declined to join Part IV of the opinion that had focused on protecting state corporate law from federal incursions. *Id.* at 480.

350 Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977).

> The strongest factor with me here is that I do not believe we should anticipate the Supreme Court in further retraction of Rule 10b-5. We and other courts have built up a considerable body of law in this area, and unless it is clearly undermined by *Santa Fe*, which I do not think it to be, I would stay with it until we are told otherwise.[351]

Friendly, writing for the panel majority, relied on the Second Circuit's pre–*Santa Fe* holding in *Schoenbaum*, which he distinguished from *Santa Fe*. Friendly's opinion held:

> *Schoenbaum* . . . can rest solidly on the now widely recognized ground that there is deception of the corporation (in effect, of its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests (in effect, the minority shareholders' interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction.[352]

For Friendly, this differed from *Santa Fe*, in which the trial court had found there was neither nondisclosure nor misleading disclosure; in *Goldberg*, there was deceit on the minority shareholders that violated the fundamental purpose of the Act's philosophy of full disclosure.[353] Meskill, a former Connecticut governor who had been nominated by President Gerald Ford, put the issue starkly in a memorandum to his colleagues:

> [R]eversal would render *Green* a nullity. Goldberg's theory appears to be that directors are liable for failing to denounce their own proposal. We can fairly assume that few crooks will label their fraudulent schemes as such. Thus virtually all breaches of fiduciary duty will fall within 10b-5, precisely the opposite of the result intended by *Green*.[354]

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351 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to William H. Timber & Thomas J. Meskill, Judges, U.S. Court of Appeals for the Second Circuit 3 (June 10, 1977) (on file with Henry Friendly Collection, Harvard Law School, Box 83, Folder 14) [hereinafter Memorandum from Henry J. Friendly].

352 *Goldberg*, 567 F.2d at 217. Louis Loss, responding after Friendly sent him the opinion, focused on the distinction between fairness and fraudulent:

> Bravo on your *Goldberg* opinion! If I may say so, we agree entirely. On the one hand, I could never understand why most of my academic brethren so enthusiastically hailed *Schoenbaum* as equating Rule 10b-5 with "fairness" when the *holding* (*pace* some of the language) could so readily be explained on the basis of a fraudulent scheme that had not been disclosed to *stockholders*. On the other hand, as I have always read *Schoenbaum*, I see nothing inconsistent in what the Supreme Court held in *Santa Fe Industries*.

Given that distinction, Loss expressed concern over Friendly's use of "unfair transaction" and suggested using "fraudulent" instead. Letter from Louis Loss, Professor of Law, Harvard Univ., to Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit 1 (Sept. 14, 1977) (on file with Henry Friendly Collection, Harvard Law School, Box 83, Folder 14). Friendly made the change when the petition for rehearing was denied.

353 *Goldberg*, 567 F.2d at 218.

354 Memorandum from Thomas J. Meskill, Judge, U.S. Court of Appeals for the Second Circuit, to Henry J. Friendly & William H. Timber, Judges, U.S. Court of Appeals for the Second Circuit 1 (June 13, 1977) (on file with Henry Friendly Collection, Harvard Law School, Box 83, Folder 14).

Friendly, who had distributed his memorandum a few days before, acknowledged the difficulty presented by *Santa Fe* but adhered to *Schoenbaum* and the Second Circuit's existing precedent:

> When I heard of the Supreme Court's reversal of our decision in *Santa Fe v. Green*, my very first thought was that this would put on the line the correctness of our *en banc* decision in *Schoenbaum* . . . that non-disclosure or faulty disclosure to stockholders of a transaction which constituted breach of fiduciary duty came within Rule 10b-5 even when stockholder action was not required by state law and has not been sought. . . . Although I recognize that the issue is exceedingly close, I would adhere to our decision, which followed and has been followed by many decisions in other circuits and approved by commentators rather than simply assume that the Supreme Court meant to knock over such a large body of law.[355]

A month later, after working on the opinion, Friendly was firmer in his belief:

> I really don't believe that the Supreme Court meant to destroy the considerable body of law represented by *Schoenbaum* or that it will do so when the issue is presented. Even more clearly, we should not anticipate them.[356]

Friendly and the Second Circuit were not alone in their efforts to limit *Santa Fe*. Five other circuits made similar decisions; dissents in two of those raised issues similar to those identified by Meskill.[357] The Supreme Court denied certiorari in *Goldberg* and two of the other cases in which certiorari was sought. The issues left by *Santa Fe* remain unaddressed by the Supreme Court.

Friendly's minimalist approach could also draw support from the insider trading doctrine discussed in Part I. Courts that had been resisting including silence as fraud (along with affirmative lies and half-truths) were by 1968 in *Texas Gulf Sulphur* clearly identifying nondisclosures as fraudulent. Even the restrictive decisions in *Chiarella* and *Dirks* accepted nondisclosure as a basis for fraud—so long as the trader who was silent had a duty of trust and confidence. *Schoenbaum* rested on a parallel line of reasoning—nondisclosure in the corporate mismanagement setting was proscribed by Rule 10b-5 if directors and officers had a duty to disclose. Even so, the weight of Powell's narrow approach seemed to grow stronger over time as mismanagement cases dried up in federal court; state law provided easier pickings for plaintiff's

355 Memorandum from Henry J. Friendly, *supra* note 351, at 1 (citation omitted).

356 Memorandum from Henry J. Friendly, Judge, U.S. Court of Appeals for the Second Circuit, to William H. Timber & Thomas J. Meskill, Judges, U.S. Court of Appeals for the Second Circuit 1 (July 12, 1977) (on file with Henry Friendly Collection, Harvard Law School, Box 83, Folder 14).

357 Kas v. Fin. Gen. Bankshares, Inc., 796 F.2d 508, 512 (D.C. Cir. 1986); Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 645–47 (3d Cir. 1980); Ala. Farm Bureau Mut. Cas. Co. v. Am. Fid. Life Ins. Co., 606 F.2d 602, 614 (5th Cir. 1979); Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273, 1291–92 (9th Cir. 1979); Wright v. Heizer Corp., 560 F.2d 236, 249–51 (7th Cir. 1977). *Healey* and *Alabama Farm Bureau* were both 2–1 opinions.

lawyers.[358] In the decades since, expansion of federal securities laws in the Sarbanes-Oxley[359] and Dodd-Frank Acts[360] have permitted the growth of federal corporate law at the expense of state law that *Santa Fe* sought to discourage, but the effort has been driven by Congress, not the courts.

Conclusion

The Supreme Court, in a handful of securities cases between 1962 and 1972, looked to statutory purpose, giving it precedence in the task of interpretation. The Supreme Court's interpretive freedom got plenty of support from other actors in the field of securities law. An SEC decision—*Cady, Roberts*—was a crucial catalyst to the decade's expansion of the securities laws. Moreover, the Second Circuit played a central role as the vanguard of the revolution in federal corporate law. Under the guidance of New Deal judges like Charles Clark, the Second Circuit had laid the groundwork in the 1950s for the Supreme Court's liberal turn in securities law in the 1960s. In the Sixties, the Second Circuit helped to build the legal structure that the Supreme Court had begun, even if justices like William O. Douglas and Arthur Goldberg would not dally long over the intricacies of securities law.

Henry Friendly was the chief architect, taking over the mantle as the Second Circuit's leading judge on securities law, a role arguably played by the more progressive Clark until his death after *Capital Gains*. When Friendly died twenty years after Clark's passing, Louis Loss, the nation's foremost authority on securities law, declared that Friendly, "without a doubt, did more to shape the law of securities regulation than any judge in the country."[361] Friendly likely had to cede that title to Lewis Powell by the time the full history of securities law in the twentieth century was written, but there was little reason to question Friendly's status as the preeminent jurist in the field during the late 1960s and well into the 1970s.

At the Supreme Court, *Capital Gains* suggested that the activist Goldberg might become the leader of the Court in the field of securities, but his tenure proved too short for him to have any lasting impact on the field. The Court's path might have been quite different if President Lyndon Johnson had accepted Earl Warren's recommendation and nominated Goldberg as Warren's successor.[362] Goldberg's departure meant that the Supreme Court lacked a dominant figure in the field until Powell's arrival in 1972. Douglas,

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358 Only one of the circuits in the previous note had a subsequent decision revisiting the *Goldberg*-era rulings. *See* LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931–32 (7th Cir. 1988) (limiting Rule 10b-5 to investment decisions, not other decisions such as litigation).

359 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of the 15, 18, 28, and 29 U.S.C.).

360 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 5, 7, 12, 15, 22, 26, 28, 31, and 42 U.S.C.).

361 Loss, *supra* note 29, at 1723.

362 Stebbene, *supra* note 143, at 374.

never that engaged with securities law after leaving the SEC,[363] was a shadow of his former self.[364] Harry Blackmun's equally liberal impulses were not backed by expertise and he could not provide a consistent counterweight to Powell. *Bankers Life* and *Affiliated Ute* marked the end of the purposive era for securities law in the Supreme Court.

Notwithstanding the lack of a Justice strongly engaged with the field, the Sixties Court, aided by the Second Circuit, produced a revolution in federal securities laws. Insider trading, seemingly confined by the 1934 Congress to a bulky and confining home in section 16(b), moved (pushed by the SEC) to the broader and more malleable antifraud space provided by Rule 10b-5. Of greater economic significance, the Supreme Court embraced implied rights of action in Rules 10b-5 and 14a-9. Coupled with the revised Federal Rule of Civil Procedure 23, the newly discovered private rights of action enabled a private regime of securities enforcement with enormous consequences for public companies and the professionals who service them. Both of these trends were driven, at least in part, by the perception that state courts had long been lax in enforcing fiduciary duty. This new activism by federal courts—the advent of a federal corporate law—had been long anticipated by progressives.

The purposive revolution, however, did not survive for long. Many of the changes set in motion by the Sixties Court were cut back in the next decade as a more conservative Supreme Court, under the influence of Powell, took a more restrictive view of securities laws, more firmly rooted in statutory text. Despite the demise of purposivism in securities law at the Supreme Court, some threads from the earlier period survived. Powell himself accepted the grafting of insider trading on to Rule 10b-5. More significant still, the Court's adoption of the misappropriation theory in 1997 in the *United States v. O'Hagan* gave insider trading a scope nearly as broad as *Texas Gulf Sulphur* had anticipated. Moreover, the Roberts Court has continued to validate securities class actions in the twenty-first century.[365] These suits have survived despite (and in part because of) a substantial congressional trimming in enacting the Private Securities Litigation Reform Act over President Clinton's veto in 1995.[366] Despite the trimming, that legislation implicitly accepted the existence of private claims and class actions under Rule 10b-5 as the regulatory baseline. The seeds planted by the Sixties Court in cases like

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363 *See* Pritchard & Thompson, *supra* note 1, at 919.

364 Douglas had lost interest in his job by the Sixties and started delegating opinion writing to his clerks. *See* Bruce Allen Murphy, *Fifty-Two Weeks of Boot Camp*, *in* IN CHAMBERS: STORIES OF SUPREME COURT LAW CLERKS AND THEIR JUSTICES, *supra* note 144, at 186, 187–88.

365 A.C. Pritchard, Halliburton II*: A Loser's History*, 10 DUKE J. CONST. L. & PUB. POL'Y 27 (2015); A.C. Pritchard, *Securities Law in the Roberts Court: Agenda or Indifference?* 37 J. CORP. L. 105 (2011).

366 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered subsections of 15 U.S.C. §§ 77–78 (2012)).

Capital Gains and *J.I. Case* may not have produced a full-blown federal corporate law of the sort sought by William Cary and other progressives, but they surely survive at the center of securities regulation today.