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Taking Section 10(b) Seriously: Criminal Enforcement of SEC Rules

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TAKING SECTION 10(B) SERIOUSLY: CRIMINAL ENFORCEMENT OF SEC RULES

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This Article examines the role of section 10(b) of the Securities Exchange Act and Rule 10b-5 in public and private enforcement actions. The Securities and Exchange Commission ("SEC") promulgated Rule 10b-5 with little fanfare. Although Rule 10b-5 was intended to be a limited expansion of the Exchange Act, it now dominates securities litigation, both public and private.

The Supreme Court has reflexively used section 10(b) to determine the contours of private action under Rule 10b-5. The Court has interpreted section 10(b) as either prohibiting certain conduct or authorizing the SEC to regulate a limited scope of conduct. This Article argues that this interpretation is not consistent with the language, structure, or legislative history of the Exchange Act.

By interpreting section 10(b) in this manner, the Court has created causes of action that have no basis in the Exchange Act, including the fraud on the market class action. Congress has often rejected the Court's approach to section 10(b), or at least failed to ratify its decisions, as it has done with the fraud on the market class action. This Article argues that the Court should revisit its decisions under section 10(b) and Rule 10b-5 and eliminate the fraud on the market class action.

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I. INTRODUCTION

The most important provision of the securities laws is not in any federal securities statute. It is Securities and Exchange Commission ("SEC" or "the Commission") Rule 10b-5, adopted quietly and without any expectation that it would become very important. Nevertheless, Rule 10b-5[1] has become one of the best-known provisions of American law. "[I]t is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little."[2]

The Supreme Court set out its approach to Rule 10b-5 almost forty years ago in *Ernst & Ernst v. Hochfelder*.[3] Although the Court held that in a private action for a violation of Rule 10b-5 a plaintiff must show that the defendant acted with scienter, it did not pay much attention to Rule 10b-5. Instead, it focused on the language of section 10(b) of the Securities Exchange Act (the "Exchange Act"),[4] because "[t]he starting point in every case involving construction of a statute is the language itself."[5] The Court underscored the centrality of section 10(b) in its response to the argument that the language of the rule covers negligent behavior:[6]

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1 17 C.F.R. § 240.10b-5 (2013).

2 7 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 498 (4th ed. 2006).

3 425 U.S. 185 (1976).

4 15 U.S.C. § 78j(b) (2012).

5 *Hochfelder*, 425 U.S. at 197 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975)).

6 Four years later, in Aaron v. SEC, 446 U.S. 680 (1980), the Court itself held that negligent conduct is covered by the second and third clauses of section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), the language of

> Rule 10b-5 was adopted pursuant to authority granted the Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." Thus, despite the broad view of the Rule advanced . . . in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b).[7]

The Court has continued to follow the approach of *Hochfelder*, consciously focusing on the language of section 10(b) instead of Rule 10b-5 to determine whether the rule prohibits certain conduct.[8] Often the Court is quite clumsy in read-

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which is used in Rule 10b-5. *See Hochfelder*, 425 U.S. at 212 n.32; *see also infra* Part IV.

7 *Hochfelder*, 425 U.S. at 212–14 (citations omitted).

8 *See, e.g.*, Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2881 (2010) ("Rule 10b-5 . . . does not extend beyond conduct encompassed by § 10(b)'s prohibition." (internal quotation marks omitted)); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008); United States v. O'Hagan, 521 U.S. 642, 651–54 (1997); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 172–73 (1994) ("In our cases addressing § 10(b) and Rule 10b-5, we . . . have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute."); *id.* at 175; *id.* at 177 ("It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text."); Aaron v. SEC, 446 U.S. 680, 689–90 (1980) (emphasizing the primacy of "the plain meaning of the language of § 10(b)"); Chiarella v. United States, 445 U.S. 222, 234 (1980); Santa Fe Indus. v. Green, 430 U.S. 462, 471–72 (1977) ("In holding that a cause of action under Rule 10b-5 does not lie for mere negligence [in *Hochfelder*], the Court began with the principle that '[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [1933 and 1934] Acts must . . . rest primarily on the language of that section,' and then focused on the statutory language of § 10(b) . . . . The same language and the same principle apply to this case." (citation omitted)); *cf.* SEC v. Zandford, 535 U.S. 813, 816 n.1 (2002) ("The scope of Rule 10b-5 is coextensive with the coverage of § 10(b); therefore, we use § 10(b) to refer to both the statutory provision and the Rule." (citations omitted)).

While the Court has focused on the language of section 10(b) in determining the scope of prohibited conduct, it has considered external sources, including policy, in defining the elements and parameters of the private ing section 10(b). The Court's reading is unfortunately exemplified by *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[9] in which the Court rejected scheme liability under Rule 10b-5, notwithstanding the language of the rule that makes it unlawful "to employ any device, scheme, or artifice to defraud."[10] According to *Stoneridge*, there is no such liability because section 10(b) does not prohibit this conduct, and "Rule 10b-5 encompasses only conduct already prohibited by § 10(b)."[11]

Stoneridge, however, was wrong about section 10(b). The Court apparently thought that the language of section 10(b) justified its blunt statement, inasmuch as it made the statement at the beginning of its discussion and immediately after quoting the statute and the rule. As the Court put it:

> Section 10(b) of the Securities Exchange Act makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[12]

On any reading, it is clear that nothing is "already prohibited" by section 10(b). Instead, section 10(b) makes unlawful, or prohibits, certain conduct only if it contravenes an

right of action for violations of the rule. *See infra* note 96 and accompanying text.

9 552 U.S. 148 (2008).

10 17 C.F.R. § 240.10b-5(a).

11 552 U.S. 157 (2008).

12 *Id.* at 156. The scope of section 10(b) extends to some instruments that are not securities. The Commodity Futures Modernization Act of 2000 amended section 10(b) to extend its coverage to "any securities-based swap agreement." Pub. L. No. 106-554, § 303(d), 114 Stat. 2763. Such swaps are not securities. Exchange Act § 3A(b), 15 U.S.C. § 78c-1(b) (2012).

SEC rule. In other words, absent a rule, section 10(b) does not prohibit anything. Even when there is a rule, it is the rule that prohibits conduct—section 10(b) does not come into play unless some conduct violates a rule. All section 10(b) does is make the rule violation unlawful. It turns out that, under the Exchange Act, a great deal turns on whether the conduct that contravenes a rule is unlawful or just prohibited.[13]

While *Stoneridge* echoed other Supreme Court opinions that have said that Rule 10b-5 prohibits only conduct that section 10(b) itself prohibits,[14] the Court has not always been so clumsy, or at least not so clumsy in the same way. Sometimes it has read section 10(b) to grant the SEC rulemaking power, but only power to regulate manipulative or deceptive devices or contrivances.[15] This interpretation, however, is also wrong. The Exchange Act explicitly grants the Commis-

13 *See infra* Part II.

14 *See, e.g.*, *Zandford*, 535 U.S. at 816; The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 589–90 (2001) ("§ 10(b) of the Securities Exchange Act of 1934 . . . prohibits using 'any manipulative or deceptive device or contrivance' 'in connection with the purchase or sale of any security.'"); *O'Hagan*, 521 U.S. at 651 (1997) ("Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition."); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994) ("We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute."); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971) ("Section 10(b) outlaws the use 'in connection with the purchase or sale' of any security of 'any manipulative or deceptive device or contrivance.'").

15 *See* Chiarella v. United States, 445 U.S. 222, 234–35 (1980); Santa Fe Indus. v. Green, 430 U.S. 462, 471–72 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) ("[D]espite the broad view of the Rule advanced . . . in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b)."); *see also infra* note 83 (listing cases in which the Supreme Court said that the SEC adopted Rule 10b-5 pursuant to section 10(b)). In these cases, the Court seems to have assumed that Rule 10b-5 prohibits everything that section 10(b) allows it to prohibit, treating the rule as "a sort of long-arm provision in which the SEC forbids everything the statute gives it power to forbid." Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 463 (1990); *see also Zandford*, 535 U.S. at 816 n.1 ("The scope of Rule 10b-5 is coextensive with the coverage of § 10(b) . . . .").

sion ample rulemaking power elsewhere.[16] Section 10(b) refers to rules prescribed by the SEC and provides for their enforcement, but it does not authorize the SEC to make rules. Moreover, inasmuch as all the conduct that the Court says is manipulative or deceptive is wrongful and harmful, if section 10(b) were about making law, Congress presumably would have just prohibited it directly, rather than leaving it to SEC regulation.[17]

If section 10(b) controls the scope of federal securities regulation, we should take section 10(b) seriously.[18] The Supreme Court has been wrong about section 10(b) since it decided *Hochfelder*. This Article offers a different reading of section 10(b). It shows that judging by the language, structure, and history of the Exchange Act, section 10(b) simply subjects a subset of SEC rule violations to criminal sanctions. Section 10(b) does not confer rulemaking power on the SEC, but it also does not limit the SEC's rulemaking power or enforcement of its rules.

The key to understanding section 10(b) lies in the Exchange Act's sanctioning scheme. The SEC can enforce any of its rules in court or administrative proceedings. Criminal sanctions, by contrast, are available for only some rules—specifically for rules "the violation of which is made unlawful or the observance of which is required under the terms of" the Act.[19] Section 10(b) triggers this criminal sanction by

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16 *See* 15 U.S.C. § 78w(a)(1) ("The Commission . . . shall . . . have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which [it is] responsible or for the execution of the functions vested in [it] by this title . . . ."); *see also infra* Parts III & IV.

17 Indeed, when Rule 10b-5 was adopted, section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), already directly prohibited most of the conduct that Rule 10b-5 prohibited. *See infra* Part IV.

18 It is not the purpose of this Article to defend or recommend textual interpretation of the Exchange Act generally or of section 10(b) particularly. The story told here is largely a cautionary one about the problems the Supreme Court has encountered in one of its most sustained textualist undertakings, and how its interpretation of section 10(b) to determine the law of Rule 10b-5 is wrong.

19 15 U.S.C. § 78ff(a).

making it "unlawful" to use manipulative or deceptive devices or contrivances in contravention of SEC rules. The criminalization of certain rule violations is an important function, but one very different from the function the Supreme Court assumes section 10(b) serves. The Court had it backward in *Hochfelder* when it looked for a limitation on Rule 10b-5 in "the power granted the Commission by Congress under § 10(b)."[20] Rule 10b-5 does not implement section 10(b); section 10(b) implements Rule 10b-5.[21]

Part II of this Article outlines the sanctions available under the Exchange Act for enforcing the Act and rules adopted thereunder. It shows that, contrary to conventional wisdom, not all SEC rules are subject to criminal enforcement, and illustrates how section 10(b) is part of an elegant mechanism designed to limit criminal enforcement of the rules. Part III discusses the SEC's extraordinarily broad rulemaking power under the Exchange Act. Part IV briefly recounts the adoption of Rule 10b-5, clarifying its statutory basis and the limited expansion of the law it was intended to secure. Part V begins to disentangle section 10(b) and Rule 10b-5. It shows that the administration of the securities laws can be regularized and the public interest furthered if courts and regulators recognize distinctions between public and private enforcement of Rule 10b-5 that are implicit in the statute, notwithstanding that the private action is a judicial creation. The Supreme Court should take responsibility for the private right of action and consider substantially restricting causes of action that it created. On the other hand, inasmuch as section 10(b) has little to do with the SEC, the Court's restrictive holdings in Rule 10b-5 cases should not apply to enforcement actions brought by the Commission, but only to

20 *Hochfelder*, 425 U.S. at 212–14 (citations omitted).

21 As much as this is at odds with the conventional understanding of section 10(b), it is just an example of a New Deal legislative convention that employed "rulemaking grants coupled with a statutory provision imposing sanctions on those who violate the rules." Thomas W. Merrill & Kathryn Tongue Watts, *Agency Rules with the Force of Law: The Original Convention*, 116 HARV. L. REV. 467, 469 (2002); *see infra* note 69 (discussing Merrill & Watts' treatment of the Exchange Act).

private and, sometimes, criminal actions. For the same reason, the Court's consistent and insistent rejection of the SEC's interpretation of section 10(b) turns out to be oddly principled. Part V concludes by showing that Congress has repeatedly rejected the Court's approach to section 10(b), which cannot withstand extension to other well-established parts of the statutory regulatory scheme.

II. ENFORCEMENT OF RULES UNDER THE EXCHANGE ACT

While the Exchange Act directly forbids some conduct—primarily acting in various capacities without registering with the SEC first[22]—it generally foregoes direct statutory regulation in favor of regulation by the SEC. This approach was a concession to the securities industry, which insisted that rigid rules contained in a statute would be unsuitable for complicated and evolving practices. Led by the New York Stock Exchange, the industry urged Congress to reject the original proposals for stock market reform and instead create a new regulator with plenary rulemaking power.[23] Congress

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22 *See* 15 U.S.C. § 78c-3 (engaging in security-based swaps not cleared through registered clearing agency); *see id.* § 78c-5 (accepting funds from security-based swap customers without registering as broker or dealer); *see id.* § 78e (effecting transactions on unregistered exchange); *see id.* § 78f(h) (trading in unregistered security futures products); *see id.* § 78i (prohibiting certain manipulative acts); *see id.* § 78k (prohibiting exchange member's trading on exchange for own account); *see id.* § 78k-1(b) (acting as securities information processor without registration); *see id.* § 78*l* (trading unregistered securities on exchange); *see id.* § 78n(e) (prohibiting the use of manipulative or deceptive devices in connection with tender offers); *see id.* § 78o(a) (acting as broker or dealer without registration); *see id.* § 78o(e) (prohibiting use of manipulative or deceptive devices by brokers and dealers); *see id.* § 78o-4 (acting as municipal securities dealer without registration); see *id.* § 78o-5 (acting as government securities broker or dealer without registration); *see id.* § 78o-10 (acting as security-based swap dealer without registration); *see id.* § 78p(c) (prohibiting sales against the box by insiders); *see id.* § 78q-1 (acting as clearing agency without registration); *see id.* § 78dd-1 (foreign bribes); *see id.* § 78dd-3 (foreign trade practices).

23 *See* H.R. REP. No. 73-1383, at 6 (1934) ("Representatives of the stock exchanges constantly urged a greater degree of flexibility in the

ultimately agreed, concluding, in the words of *Hochfelder*, "that efficient regulation of securities trading could not be accomplished under a rigid statutory program."[24] Thus, the Exchange Act "merely specifies the practice or type of transactions to be regulated, and indicates the objective to be gained. Within the statutory limitations, the scope of these qualified or conditional prohibitions is determined by the rules and regulations . . . ."[25]

The Exchange Act established a menu of options for enforcing the statute and the SEC's rules. For a long time, injunctive relief was the primary enforcement mechanism available to the SEC.[26] The Exchange Act provides that

statute and insisted that the complicated nature of the problems justified leaving much greater latitude of discretion with the administrative agencies than would otherwise be the case. It is for that reason that the bill in dealing with a number of difficult problems singles out these problems as matters appropriate to be subject to restrictive rules and regulation, but leaves to the administrative agencies the determination of the most appropriate form of rule or regulation to be enforced."); *Whitney Proposes A Federal Board on Stock Trading–Favors a Stock Exchange Coordinating Authority with Plenary Powers*, N.Y. TIMES, Feb. 23, 1934, at 1, col. 5 (Richard Whitney was president of the New York Stock Exchange); Press Release, N.Y. Board of Trade (Apr. 12, 1934) (announcing Board's unanimous resolution proposing a Stock Exchange Coordinating Authority with "plenary powers with respect to all necessary rules and regulations that will prevent fraudulent practices, the use of excessive credit for security speculation, and the manipulation of security prices."), *quoted in* Thel, *supra* note 15, at 441 n.252. *See generally id.* (discussing substitution of plenary rulemaking power for statutory restrictions in response to insistence of securities industry).

24 425 U.S. 185, 195 (1976).

25 William B. Herlands, *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 169 (1934); *see also* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 100 (3d ed. 2003) (observing that debate over enactment of Exchange Act was generally resolved by conferring rulemaking power on the SEC).

26 *See* Comm. on Fed. Regulation of Sec., *Report of the Task Force on SEC Settlements*, 47 BUS. LAW. 1087, 1098 (1992) [hereinafter *SEC Task Force Report*] ("Injunctive relief has been the SEC's principal enforcement remedy under the express provisions of the federal securities laws, traditionally regarded as the 'remedy of choice' for the Commission.").

> Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder [or the rules of self-regulatory organizations] . . . it may in its discretion bring an action . . . to enjoin such acts or practices.[27]

The SEC has the same power to obtain injunctive relief for violations of the rules it promulgates under the Exchange Act as it has for violations of the Exchange Act itself.

In 1990, the Exchange Act was amended to allow the SEC to seek civil money penalties in court "[w]henever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of [the Exchange Act], the rules or regulations thereunder," or in some cases, the rules of self-regulatory organizations.[28] Here again, violations of the statute and rules are treated alike, and civil money penalties are available for the violation of any Exchange Act rule.

As originally enacted, the Exchange Act also authorized the SEC to impose administrative sanctions in certain circumstances,[29] and it has been amended repeatedly to afford the Commission a range of administrative sanctions.[30] Once again, the Exchange Act does not distinguish between statutory provisions and rules, and thus the Commission's administrative sanctions are available to enforce all its rules.

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27 15 U.S.C. § 78u(d); *see also id.* § 78u(e) (granting court jurisdiction for violation of all rules); *cf. id.* § 78t(e) (allowing SEC to obtain injunctions against those who aid and abet the violation "of any rule or regulation").

28 15 U.S.C. § 78u(d)(3); *see* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 201, 104 Stat 931, 935 (1990).

29 *See, e.g.*, Exchange Act § 19, 48 Stat. 881, 898 (1934) (since amended) (suspension of exchange or security registration).

30 *See* 15 U.S.C. § 78o(b)(4)(D) (discipline of broker-dealers); *see id.* § 78u-2(a) (civil penalties in certain administrative proceedings for willful violations of "the rules or regulations" under the Exchange Act); *see id.* § 78u-3(a) (cease and desist orders for violations of "any rule or regulation" under the Exchange Act).

Finally, the Exchange Act provides for criminal enforcement in section 32.[31] Although criminal proceedings were not intended to be the primary enforcement mechanism, they are of course very important.[32] The criminal sanction provision of the Exchange Act, however, is very different from the civil and administrative enforcement provisions. While criminal penalties are available for willful violation of any section of the statute (except one provision dealing with foreign bribes),[33] they are available for only a subset of SEC rules.

The leading treatise on securities regulation reflects conventional wisdom when it says that it is a crime to violate any rule adopted by the SEC under the Exchange Act willfully.[34] In fact, however, while every provision of the Exchange

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31 *See* 15 U.S.C. § 78ff. The Exchange Act expressly provides some private remedies. *See, e.g.*, *id.* §§ 78i(e), 78p(b), 78r. With the exception of section 16(b), which allows for the recovery of short-swing trading profits from some corporate insiders, these express remedies have not proven important. Moreover, the section 16(b) remedy is not for a violation of the Act. The short-swing trading for which it affords a remedy is not prohibited, and neither the SEC nor the DOJ may enforce section 16(b). In any event, the statutorily expressed private remedies do not empower private parties to recover for rule violations. The judicially created implied private action for violations of Rule 10b-5, on the other hand, is extremely important.

32 *See* Herlands, *supra* note 25, at 144–45.

33 The excluded statutory provision, Exchange Act § 30A, 15 U.S.C. § 78dd-1, was added to the Exchange Act by the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 103(a), 91 Stat. 1494, 1495, which also amended section 32 to exclude the provision from criminal sanction thereunder. *See id.* § 103(b)(1).

34 *See* 10 LOSS, SELIGMAN & PAREDES, *supra* note 2, at 412; *see also* JOHN C. COFFEE & HILLARY A. SALE, SECURITIES REGULATION 1499 (12th ed. 2012) (It is "a felony for any person 'willfully' to violate any statutory provision of [the Securities Act or the Exchange Act] or any rule or regulation promulgated thereunder. Any SEC rule or regulation . . . can support a criminal prosecution . . . ."); JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION 863 (6th ed. 2009) ("[It is a]crime for any person to 'willfully' violate . . . any rule or regulation promulgated" under the Exchange Act); Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: the Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1040–41 (2001)

Act but one may be enforced with criminal sanctions, not all rules are enforceable criminally. Instead, criminal sanctions extend only to the willful violation of "any rule or regulation [under the Exchange Act] the violation of which is made unlawful or the observance of which is required under the terms of" the Act.[35]

The awkward language of section 10(b) becomes clear when read against the equally awkward language of section 32.[36] Recall that section 10(b) literally only provides that certain conduct in contravention of SEC rules "shall be unlawful."[37] Calling something unlawful usually does not do very much. Murder, speeding, and breaking a contract are all unlawful acts, but the law treats them very differently. The consequence of unlawfulness is what matters.[38] Section 32 provides the consequences for rule violations that section 10(b) makes unlawful—criminal sanctions. By making the use of manipulative or deceptive devices or contrivances in contravention of an SEC rule "unlawful," section 10(b) triggers criminal sanctions under section 32, which apply to rules whose violation is made "unlawful" by the Exchange

(criminal actions "can rest on the violation of any prohibition in the Exchange Act and its accompanying rules and regulations").

35 15 U.S.C. § 78ff(a). The Exchange Act's treatment of criminal penalties for rule violations differs from that of the Securities Act of 1933, which subjects willful violations of any rule promulgated under that Act to criminal penalty. *See id.* § 77x. When the Exchange Act was enacted, the difference—in statutes created by the same committees and enacted by the same Congress—was noted as evidence that Congress intended to limit the range of rules subject to criminal prosecution under the Exchange Act. *See* Herlands, *supra* note 25, at 143–44.

36 *Cf.* United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 371 (1988) ("Statutory construction . . . is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme.").

37 *See supra* text accompanying note 13.

38 *See* United States v. Izurieta, 710 F.3d 1176, 1181–82 (11th Cir. 2013) (holding that violation of a regulation could not be basis of criminal prosecution under 18 U.S.C. § 545 (2006), which covers importation "contrary to law"); *cf.* Gabelli v. SEC, 133 S.Ct. 1216, 1219 (2013) (using "illegal" as synonym for "unlawful" in Investment Advisers Act Section 206, 15 U.S.C. § 80b-6).

Act. The "[i]t shall be unlawful . . . to . . ." language in section 10(b) is shorthand for "[i]t shall be a crime punishable upon conviction by fine of not more than $5,000,000, or imprisonment of not more than 20 years if the defendant does not prove that he had no knowledge of the rule, or both, or fine not exceeding $25,000,000 in the case of a person other than a natural person, to . . . ."[39]

The language of section 32 limiting criminal sanctions to a subset of rules was not a drafting glitch. Rather, it was the product of considerable legislative attention to widely held concerns about the propriety of granting an administrative agency license to create new crimes. Its inclusion was a condition for the criminalization of rule violations.[40] The first versions of what became the Exchange Act would have made the willful violation of any Commission rule a crime subject to fine and imprisonment.[41] Critics of these proposals argued that no administrative agency should be granted broad power to define crimes.[42] The bill subsequently passed by

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39 15 U.S.C. § 78ff(a); 17 C.F.R. § 240.10b-5.

40 *See* Herlands, *supra* note 25, at 171–73; Thel, *supra* note 15, at 456–59. When the Exchange Act was enacted, there were substantial questions about the extent to which Congress could allow an administrative agency to make conduct criminal. *See* Herlands, *supra* note 25, at 169–71. It is also noteworthy that the criminal sanctions of section 32 do not reach self-regulatory organization rules, which the SEC can enforce in civil proceedings. *See supra* notes 26–27 and accompanying text. Enforcing privately promulgated rules with criminal sanctions might have seemed particularly problematic in 1934. The next year, the Supreme Court found delegation of rulemaking power to private entities unconstitutional in *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935), and *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935).

41 *See* H.R. 7852, 73d Cong. § 24 (1934); H.R. 8720, 73d Cong. § 25 (1934); H.R. 9323, 73d Cong. § 32 (1934); S. 2693, 73d Cong. § 24 (1934); *see also Stock Exchange Practices: Hearings Before the S. Comm. on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.)*, 73d Cong. 6576 (1934) [hereinafter *Senate Hearings*] (testimony of Thomas Corcoran describing provision); *id.* at 6640 (testimony of Richard Whitney, President, NYSE).

42 *See, e.g.*, *id.*, at 7562 (testimony of Roland Redmond, counsel to NYSE) (referring to an earlier version of what became section 10(b) as "a general grant of [rulemaking authority] to the [FTC] to define as a crime

the House of Representatives limited criminal enforcement of rules to those "the violation of which is made unlawful under the terms of this Act."[43] The Senate then approved its own bill, which allowed all rules to be enforced by injunction, subjected willful violations of the statute to fine and imprisonment, and subjected willful violations of any rule to fine alone.[44] The enacted compromise subjected rule and statute violations to the same criminal sanctions—fine and imprisonment—but restricted criminal sanctions to rules "the violation of which is made unlawful or the observance of which is required under the terms of" the Act.[45] It also added the unusual provision that no one may be imprisoned for a rule violation if he proves he was ignorant of the rule, further ev-

any practice which they thought was manipulative, [which] seemed to us to be an altogether too broad grant of power to an administrative body."); *id.* at 7572 ("We firmly believe that the criminal penalties of the bill ought to be restricted to what are really in their nature crimes, and not violations of rules and regulations . . . ."); *id.* at 6965 (testimony of Howard Butcher, Jr., of the Philadelphia Stock Exchange) ("[H]e would become immediately become subject to a $25,000 fine and/or a 10-year jail sentence . . . for violating, perhaps entirely unwittingly, some provisions of the rules and regulations . . . ."); *id.* at 7022 (statement of New York Airbrake Co.) (fine and imprisonment for rule violations "is revolting to the sense of justice and fair play of all of us"); *cf.* 78 Cong. Rec. 8112 (1934) (statement of Rep. John Cooper) ("It is doubtful whether ever in the history of Congress such a wide and sweeping delegation has been given to any administrative body to create by rule and regulation crimes punishable by severe fine and imprisonment . . . .").

43 H.R. 9323, 73d Cong. § 32 (1934); *see also* 78 CONG. REC. 8116–17 (1934).

44 *See* S. 3420, 73d Cong. § 30 (1934); H.R. 9323 § 30 (as passed with the amendment of the Senate); *see also* S. REP. NO. 73-792, at 6 (1934) ("[A]ccordingly the bill provides criminal penalties for violation of such rules and regulations. It is to be noted, however, that such penalties are limited to fines as distinguished from the penalties of imprisonment which may be inflicted for violation of the statutory provisions of the bill."); *id.* at 23–24.

45 15 U.S.C. § 78ff (2012); *see also* H.R. REP. NO. 73-1838, at 38 (1934) (Conf. Rep.) ("The substitute contains substantially the House provision [which reached rules the violation of which is made unlawful] except that it is made clear that it is to apply to violations of rules or regulations the observance of which is required . . . .").

idencing Congress' caution about criminal enforcement of administratively promulgated rules.[46] Contemporaneous commentators recognized that section 32 limited criminal penalties to a subset of rules, and it does not appear that anyone ever suggested that all willful rule violations were subject to criminal sanction.[47]

Recognizing that section 10(b) is about criminal sanctions helps explain some of the more curious aspects of securities regulation. For example, the limited scope of section 10(b) explains the paucity of direct references to section 10(b) in the legislative history of the Exchange Act.[48] Ironically, section 10(b) is characterized as providing a sanction, not as creating rulemaking power, in the only congressional committee report that the Supreme Court has found relevant:

> The legislative reports do not address the scope of § 10 (b) . . . directly . . . . The only specific reference to § 10 . . . is the following:
>
> > "In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and de-

46 *See* 15 U.S.C. § 78ff.

47 During floor debate over the House bill, Republican Representative John Cooper criticized the extension of criminal sanctions to rule violations and listed the various provisions that triggered criminal sanctions by declaring the violation of a rule unlawful. 78 CONG. REC. 8112 (1934). Shortly after the Exchange Act was enacted, William Herlands, writing in the Virginia Law Review, noted that "[t]he penal provision . . . is confined to those rules and regulations 'the violation of which is made unlawful or the observance of which is required under the terms' of the statute. The obvious purpose of this restriction is to narrow the area of criminal conduct. [The provisions permitting injunctive and administrative enforcement of *any* rule] bring out in sharp relief the restriction in the penal provision and the Congressional intent in that regard." Herlands, *supra* note 25, at 172–73 (emphasis in original).

48 The Supreme Court has emphasized the absence of direct legislative history. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 204–05 (1976). *See generally* Thel, *supra* note 15 (detailing legislative history of section 10(b)).

> ceptive practices which have been demonstrated to fulfill no useful function. *These sanctions are found in sections 9, 10 and 16.*"[49]

Section 32's requirement that a rule be identified elsewhere in the statute before criminal sanctions can attach also helps explain this section's minimal mens rea requirement. Criminal sanctions may be imposed on anyone who "willfully violates" the statute or covered rule, which has been held to require "only that 'the prosecution establishes a realization on the defendant's part that he was doing a wrongful act.'"[50] Inasmuch as most provisions of the Exchange Act are triggered only by rule violations—and most of the rules are extraordinarily dense and obscure—students of securities regulation are often surprised to conclude that a person may be subject to criminal sanction for violating a rule he has never heard of if the government can make the minimal showing that the defendant realized he was doing wrong. However, section 32 does not only rely on the defendant's state of mind to limit the conduct that is subject to criminal sanction, but also on the requirement that the rule at issue be identified in another provision of the statute. Some of those provisions further limit the rule violations subject to criminal sanctions, as section 10(b) does by conditioning unlawfulness, and thus criminal sanction, on the defendant's use of a manipulative or deceptive device or contrivance. Others, such as the provisions relating to SEC reports and proxy statements,[51] identify rules that apply in situations that people likely know are subject to intricate regulation.[52]

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49 *Hochfelder*, 425 U.S. at 204 (quoting S. REP. NO. 73-792, at 6 (1934) (emphasis supplied)).

50 United States v. Peltz, 433 F.2d 48, 55 (2d Cir. 1970) (quoting Herlands, *supra* note 25, at 149); *see also* United States v. Dixon, 536 F.2d 1388, 1395 (2d Cir. 1976).

51 *See* 15 U.S.C. §§ 78m(a), 78n(a).

52 Section 32's limitation on the rules subject to criminal sanction apparently informed the judicial development of a relaxed standard of "willfulness." Most courts have followed the standard articulated by Judge Friendly in *Peltz*, 433 F.2d at 55, and *Dixon*, 536 F.2d at 1395. As noted

Since criminal violations of the Exchange Act and its rules are prosecuted by the Department of Justice ("DOJ"),[53] section 10(b) has little significance for the SEC within the structure of the statute. To illustrate, suppose that Rule 10b-5 was called something else, for example "Rule 105." The Commission could adopt the rule without reliance on section 10(b) under the broad rulemaking power conferred by section 23(a) of the Exchange Act.[54] If someone violated the renamed Rule 105, the SEC could obtain an injunction or administrative sanction for the violation, and would not have to prove a violation of, or, for that matter, cite, any substantive provision of the Exchange Act, let alone section 10(b). After all, under the Exchange Act, civil and administrative remedies are available for the violation of *any* rule.

Only if criminal sanctions were sought would it be necessary to identify a provision of the Exchange Act requiring observance of the rule or making its violation unlawful. For a violation of Rule 10b-5—or imaginary Rule 105—the identified provision would presumably be section 10(b). The SEC would never have to identify such a provision, however, since the U.S. Attorney would prosecute a criminal case. Moreover, to secure a conviction on the basis of section 10(b), the government would have to show not merely that the defendant violated the rule, as the SEC would have to do in a civil

below, Judge Friendly was almost uniquely cognizant among judges of section 32's limited reach with respect to rules, and in *Peltz* and *Dixon* he specifically found that the rules at issue were rules "the violation of which is made unlawful or the observance of which is required" by the Exchange Act. *See infra* note 62 and accompanying text. Judge Friendly was famously careful in reading the securities laws, and it is quite likely that his decision to adopt a lax interpretation of "willfully" was informed by the fact that the limiting language restricted criminal sanctions to a subset of rules that Congress has identified as being of substantive importance in other provisions of the Act. Certainly William Herlands, whose language Judge Friendly borrowed to define "willfully," *see Peltz*, 433 F.2d at 54–55, and whose analysis he found "penetrating," *id.* at 55, emphasized the critical importance of the limiting language in 1934. *See* Herlands, *supra* note 25, at 171–73.

53 *See* 15 U.S.C. § 78u(d) (SEC referral to the DOJ).

54 *Id.* § 78w(a); *see infra* Parts III and IV.

or administrative proceeding, but also that he "use[d] or employ[ed] . . . [a] manipulative or deceptive device or contrivance."[55]

The SEC is not likely to rename Rule 10b-5, but SEC rule numbers do not have to refer to statutory section numbers. None of the Securities Act rules do, and not all Exchange Act rules addressing manipulative and deceptive devices do either. For example, SEC Regulation M regulates trading practices in securities offerings.[56] Regulation of these trading practices is thought to be necessary because individuals publicly offering securities may buy in the market to support or stabilize the market price, and potential buyers may sell in the market to drive down the public offering price. Until recently, these practices have long been regulated under the Exchange Act by rules identified with section 10(b); the predecessor rules for Regulation M were Rules 10b-6, 10b-6A, 10b-7, 10b-8 and 10b-21.[57]

The manner in which these rules are enforced shows that the SEC can enforce rules governing manipulative or deceptive practices without reference to section 10(b) or any other substantive provision of the Exchange Act. For instance, one of the trading practice rules prohibits effecting short sales immediately before a registered public offering and then purchasing shares in the offering. This prohibition is the real Rule 105 (Rule 105 of Regulation M),[58] and Rule 10b-21

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55 *See supra* text accompanying notes 50–52. The government might also have to show that the SEC adopted the rule "in the public interest or for the protection of investors," which is not an explicit requirement of section 23(a).

56 17 C.F.R. §§ 242.101–05 (2013).

57 *See* Anti-manipulation Rules Concerning Securities Offerings, Securities Act Release No. 7375, Exchange Act Release No. 38,067, Investment Company Act Release No. 22,412, 62 Fed. Reg. 520 (Jan. 3, 1997); Trading Practices Rules Concerning Securities Offerings, Securities Act Release No. 7282, Exchange Act Release No. 37,094, Investment Company Act Release No. 21,883, 61 Fed. Reg. 17,108 (April 18, 1996); Steve Thel, *$850,000 in Six Minutes–The Mechanics of Securities Manipulation*, 79 CORNELL L. REV. 219, 290–91 (1994).

58 17 C.F.R. § 242.105.

was its predecessor.[59] The SEC can impose sanctions administratively or obtain an injunction and ancillary remedies for a violation of the rule without charging a violation of section 10(b) or any other section of the statute.[60]

Courts presented with criminal prosecutions for violations of Exchange Act rules have not always been particularly concerned with assuring that the rules in question were, per section 32, rules "the violation of which is made unlawful or the observance of which is required by the terms of" the Exchange Act.[61] Courts' inattention to section 32, however, does not mean that the limitation does not exist. A preeminent judge of securities law, Henry Friendly, was consistently careful to ensure that SEC rules were within section 32's

59 *See* Anti-manipulation Rules Concerning Securities Offerings, 62 Fed. Reg. at 538 ("The Commission is adopting Rule 105 to replace Rule 10b-21."). The SEC subsequently adopted a new Rule 10b-21 to address naked short selling. 17 C.F.R. § 240.10b-21; *see* "Naked" Short Selling Antifraud Rule, Exchange Act Release No. 58,774, 73 Fed. Reg. 61,666, 61,666 (Oct. 17, 2008).

60 *See, e.g.*, SEC v. Colonial Inv. Mgmt. LLC, 659 F. Supp. 2d 467, 470 (S.D.N.Y. 2009) (issuing injunction and ancillary equitable remedies for violation of Rule 105), *aff'd*, 381 F. App'x 27, 32 (2d Cir. 2010). No substantive provision of the Exchange Act is cited in either of the *Colonial* opinions.

61 A few reported opinions have noted the restriction, but dealt with it summarily. *See* United States v. McDermott, 131 F.2d 313, 316 (7th Cir. 1942) (discussing section 32's limitation in connection with an unconstitutional delegation argument); *see also* United States v. Schwartz, No. 66 CR 425, 1971 WL 260, at *9 (E.D.N.Y. Apr. 26, 1971) (noting in criminal prosecution for violation of Rule 8c-1, 17 C.F.R. § 240.8c-1, that section 32 "punishes (1) any person who 'wilfully [sic] violates' any regulation the violation of which is made unlawful by the Act (as section 8(c) does here)"); United States v. Pope, 189 F. Supp. 12, 21–22 (S.D.N.Y. 1960) (discussing how section 32(a), which "imposes criminal sanctions upon persons who make false statements of material facts . . . or who violate any Commission rule or regulation," applies to proxy statements); *cf.* United States v. Gagalis, No. 04-cr-126-01/06-PB, 2006 U.S. Dist. LEXIS 23517, at *9–18 (D.N.H. Mar. 20, 2006) (discussing the section 32 limitation). For further discussion of *Gagalis*, *see infra* note 65.

restrictive language in criminal cases.[62] However, some very important rules are not captured by that language.

Consider Rule 13b2-1, one of the most far-reaching rules under the Exchange Act. It provides that "[n]o person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act."[63] The books, records, and accounts to which it refers are those of publicly traded companies. Thus, the rule forbids anyone to cause the records of a publicly held company to be false. This is a huge field. For example, any employee of a public company who submits a fudged expense account violates the rule, as does a lawyer who pads hours on a bill submitted to a public company.

Rule 13b2-1 is a valid rule, and perhaps a wise one. Nothing in this Article suggests that the SEC should not enforce it. However, Rule 13b2-1 is frequently enforced criminally,[64] even though the Exchange Act neither makes a viola-

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62 In *United States v. Peltz*, Judge Friendly correctly held that Rule 10b-5 is a rule covered by section 32. *See* 433 F.2d 48, 53 (2d Cir. 1970) ("Section 32(a) . . . makes criminal any willful violation of any provision of the act or any rule or regulation thereunder the violation of which is made unlawful. Section 10(b) of the Act and the Commission's Rule 10b-5 thereunder . . . qualify under this test."). *See also* United States v. Dixon, 536 F.2d 1388, 1395 (2d Cir. 1976) (Friendly, J.) (holding that failure to include required information in form 10-K report and proxy statement "were clear violations of 'any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter,' the language of the first clause of § 32(a)" (citation omitted)). Judge Friendly is preeminent in the field of securities regulation. *See* Louis Loss, *In Memoriam: Henry J. Friendly*, 99 HARV. L. REV. 1722, 1723 (1986) ("Judge Friendly, without a doubt, did more to shape the law of securities regulation than any judge in the country."); *see also* Margaret V. Sachs, *Judge Friendly and the Law of Securities Regulation: The Creation of a Judicial Reputation*, 50 SMU L. REV. 777, 780 (1997) ("Judge Friendly achieved renown in . . . securities regulation . . . ."); Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2889–90 (2010) (Stevens, J., concurring) (describing the Second Circuit as the "mother court" of securities law and Judge Friendly as its "master arborist").

63 17 C.F.R. § 240.13b2-1; *see also* 15 U.S.C. § 78m(b)(2)(A) (2012).

64 *See* United States v. Rigas, 605 F.3d 194, 200 (3d Cir. 2010); United States v. Reyes, 577 F.3d 1069, 1073 (9th Cir. 2009); United States v.

tion of this rule unlawful, nor requires observance of the rule.[65] Rule 13b2-1 is just the sort of rule that Congress was loath to have criminally enforced.[66] The difficulty of regulating a complicated and evolving field led Congress to empower the SEC to adopt whatever rules it finds necessary or proper and to allow the agency to require compliance with those rules. Nonetheless, ensuring effective regulation does not require that Congress give the Commission equally broad discretion to decide what conduct should be subject to crimi-

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Brown, 459 F.3d 509, 516–17 (5th Cir. 2006); *see also* Stuart H. Deming, *The Changing Face of White-Collar Crime: The Potent and Broad-Ranging Implications of the Accounting and Record-keeping Provisions of the Foreign Corrupt Practices Act*, 96 J. CRIM. L. & CRIMINOLOGY 465, 484–89 (2006).

65 *See* 15 U.S.C. § 78m(b)(2) (requiring public corporations to keep good books and records and maintain sufficient internal accounting controls, but not discussing rules). Similarly, section 13(b)(5) does not discuss rules, either ("No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2)."). *Id.* § 78m(b)(5).

Gagalis involved a criminal conviction for the violation of a related rule, Rule 13b2-2, 17 C.F.R. § 240.13b2-2, which suffered from the same infirmity for purposes of criminal prosecution. No. 04-cr-126-01/06-PB, 2006 U.S. Dist. LEXIS 23517, at *4. The defendants argued that the rule exceeded the SEC's statutory rulemaking authority, but the court found that section 23 authorized it. *Id.* at *15. The defendants also argued that the rule could not serve as a basis for criminal prosecution because the Exchange Act does not make violation of the rule unlawful or require compliance with it. *Id.* at *16. The court rejected that argument, stating that it

> misses the point. Section [32] criminally punishes the violation of rules that must be observed under the Exchange Act. . . . Rule 13b2-2 was a valid exercise of the SEC's authority to promulgate regulations and thus it has the force and effect of law. Therefore, I conclude that a willful violation of Rule 13b2-2 may result in criminal liability under § [32(a)].

Id. at *17 (citation omitted). This analysis misses the point. It would subject any validly adopted SEC rule to criminal sanction and thus disregard the limitation in section 32.

66 *See* ROBERTA KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 156 (1982).

nal sanctions, and Congress did not grant such discretion in the Exchange Act.

III. THE SEC'S RULEMAKING POWER

The Exchange Act gives the SEC almost unfettered rulemaking power. Section 23(a) declares that the Commission shall "have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this [Act] . . . or for the execution of the functions vested in them."[67] The extraordinary breadth of the grant of administrative power was not controversial because, as discussed above, the securities exchanges and others who were to be regulated by the Exchange Act had proposed it.[68] Section 23(a) has always been understood to confer lawmaking authority on the SEC,[69] and since 1934, the Commission has

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67 15 U.S.C. § 78w(a)(1); *see also* Mourning v. Family Publ'ns Serv., Inc., 411 U.S. 356, 369 (1973) ("Where the empowering provision of a statute states simply that the agency may 'make . . . such rules and regulations as may be necessary to carry out the provisions of this Act,' we have held that the validity of a regulation promulgated thereunder will be sustained so long as it is 'reasonably related to the purposes of the enabling legislation.'") (quoting Thorpe v. Housing Authority, 393 U.S. 268, 280–81 (1969)). The Commission's rulemaking power under the Exchange Act is broader than its power under the Securities Act. *See* 15 U.S.C. § 77s(a) ("The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter . . . ."). *See also* SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735, 744 (1984) (incorrectly indicating that both statutes allow "necessary or proper" rules).

68 *See supra* notes 23–25 and accompanying text. Those who remained opposed to administrative rulemaking power focused on section 23 and its predecessor provisions in earlier versions of the Act. *See Stock Exchange Regulation, Hearings on H.R. 7852 and H.R. 8720 Before the H. Interstate and Foreign Commerce Comm.*, 73d Cong. 159, 227, 262, 667, 669–70 (1934); *Senate Hearings, supra* note 41, at 6938, 6993–94, 7021, 7285.

69 The Supreme Court has cited rules adopted under section 23(a) as an example of rules carrying the force of law. *See* Gen. Elec. Co. v. Gilbert, 429 U.S. 125, 141 (1976); *see also* Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S. Ct. 3138, 3163 (2010) (citing section 23 to show that the SEC's powers are generally vested in the Commissioners jointly, not in the Chair alone); *SEC Task Force Report*, *supra* note 26, at 1141 ("The

consistently relied upon section 23(a) to adopt a notoriously wide range of rules.[70]

Congress has continued to regard section 23(a) as the source of the SEC's rulemaking power. Since 1934, whenever Congress has made general changes in the SEC's rulemaking power, it has done so by amending section 23.[71] For

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SEC's general rulemaking power derives from section 23(a)(1) of the Exchange Act."); Merrill & Watts, *supra* note 21, at 510 (Section 23 has "always been regarded as conferring legislative rulemaking authority."). Merrill and Watts add:

> Section 23(a) [of the Exchange Act] provided that "the Commission and the Federal Reserve Board shall each have power to make such rules and regulations as may be necessary for the execution of the functions vested in them by this title." According to the convention, Congress indicated its intent to give legislative effect to these rules and regulations through two statutory provisions. First, [S]ection 21(e) [now § 21(d)] gave the SEC the power to bring an action seeking to enjoin the violation of any rule or regulation promulgated under the Act. Second, [S]ection 32 set forth penalties for violations of any rules or regulations promulgated by the SEC.

Id. at 510 n.215 (citations omitted). Merrill and Watts overstate the effect of section 32 when they say that it set forth criminal penalties for violation of "any" SEC rule. However, the availability of injunctive relief for the violation of any rule satisfies their test for rules with the force of law. *See id.* at 472 (noting that "some sanction" would meet the test).

70 The SEC adopted many rules, including Rule 10b-5, before the enactment of the Administrative Procedure Act ("APA"), which requires agencies to reference the legal authority under which a rule is proposed. 5 U.S.C. § 553(b)(2) (2012). Shortly after the APA was enacted, the Commission published all of its Exchange Act rules (including Rule 10b-5) in the *Federal Register*. At the end of the list of rules, under the caption "Authority," the Commission stated that all these rules were "issued under sec. 23." 13 Fed. Reg. 8177, 8178 (Dec. 22, 1948).

71 *See, e.g.*, Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429 § 204, 104 Stat. 931 (1990) (adding section 23(d) to provide for regulations for cease-and-desist proceedings). *But see* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 § 106, 110 Stat. 3416 (1996) (adding 15 U.S.C. § 78c(f), requiring the SEC to consider efficiency and capital formation in rulemaking). As discussed below, Congress has amended other sections of the Act to direct

example, in 1975, as part of a major revision of the securities laws, it amended section 23 to require the SEC to consider the potential burden on competition posed by new rules, and also replaced the Commission's original power to make "necessary" rules[72] with its current power to make "necessary or appropriate" rules.[73] As a result, Congress conferred its own broad "necessary and proper" power[74] on the SEC, but made it disjunctive. It is hard to imagine language conveying a broader grant of rulemaking authority.

Besides granting the SEC rulemaking power in section 23(a), the Exchange Act repeatedly refers to Commission rules. Most of these references take one of two forms. Some provisions, like section 10(b), state that "it shall be unlawful" to do certain activities "in contravention of such rules and regulations as the Commission may prescribe."[75] Other provisions state that certain people must do certain things "in accordance with such rules and regulations as the Commission may [or shall] prescribe."[76] For example, section 13(a) requires most publicly held companies to file periodic reports "in accordance with" SEC rules.[77]

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the SEC to adopt rules governing conduct in certain areas, such as tender offers. *See infra* notes 78–81 and accompanying text.

72 *See* Exchange Act § 23, 89 Stat. 881, 901 (1934).

73 *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 18, 89 Stat. 97, 156 (1975); *see also* S. REP. No. 94-75, at 145, 242 (1975) (Section 23(a)(1) marked to show changes from previous law). The committees responsible for the 1975 amendments recognized that the SEC's primary rulemaking power lies in section 23(a). *See, e.g.*, *id.* at 192 ("[I]n promulgating its own rules under section 23(a) . . . the Commission would be required to make specific findings as the justification for any limitation on, or restraint of, competition . . . ."); *id.* at 312 (amending "section 23 of the Exchange Act concerning rulemaking powers").

74 *See* U.S. CONST. art. I, § 8, cl. 18.

75 15 U.S.C. § 78j. *See also id.* §§ 78i(a)(6), 78i(b), 78j(a)(1), 78m(e)(1), 78n(a)(1), 78n(b)(1), 78dd; *cf. id.* §§ 78h(a), 78*l*(a), 78o(c)(3)(A) (similar language); see *id.* § 78g (Federal Reserve Board rules).

76 *See id.* §§ 78m(a), 78m(d)(2), 78m(g)(2), 78n(c), 78n(d)(4), 78o(d); *cf. id.* § 78g(c)(1)(B) (Federal Reserve Board rules).

77 *See id.* § 78m(a).

These provisions identify subjects that Congress expected the SEC to regulate, and could be read to grant the SEC rulemaking authority beyond what is found in section 23(a). However, section 23(a) confers ample rulemaking power, and construing other provisions to confer additional power does not add to the Commission's power or the Exchange Act's coherence. Moreover, unlike section 23(a), these provisions do not explicitly delegate rulemaking power to the SEC. They do, however, make the violation of certain rules a crime. The two mechanisms they employ—making the violation of rules unlawful and requiring observance of rules—are precisely the two mechanisms section 32 uses to identify rules whose violation is subject to criminal sanction.

Another set of provisions that refer to rules, manipulation, and deception—key terms of section 10(b)—reinforce the conclusion that section 10(b) is primarily a sanctioning provision. Several provisions of the Exchange Act actually prohibit the use of manipulative and deceptive acts and practices in certain circumstances.[78] These provisions, unlike section 10(b), forbid manipulation or deception, even if no SEC rule is violated. They also direct the Commission to adopt what could be called implementing rules.[79] For example, section 14(e) makes it unlawful to engage in deceptive or

78 *See* 15 U.S.C. § 78n(e) (tender offers); § 78o(c) (brokers and dealers); § 78i(d) (short sales).

79 *See id.* § 78n(e); § 78o(c)(2)(D) (brokers and dealers) ("The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative . . . ."); § 78i(d) ("The Commission shall issue such other rules as are necessary or appropriate to ensure that the appropriate enforcement options and remedies are available for violations of this subsection in the public interest or for the protection of investors."); *cf. id.* § 78m(e)(1) ("It shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 12 of this title . . . to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices.").

manipulative acts or practices in connection with a tender offer. It further provides that the SEC "shall, for purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."[80] The fact that these sections of the Exchange Act direct, rather than authorize, the Commission to adopt rules suggests that the underlying power to promulgate rules lies elsewhere (i.e., in section 23(a)). If section 14(e) and other similar provisions do delegate rulemaking power, they suggest that when Congress wants to grant special rulemaking power to the Commission, it expressly states that it is doing so, rather than simply using rules as a trigger, as it did in section 10(b).[81]

IV. THE ADOPTION OF RULE 10B-5

Section 23(a) gave the SEC ample power to adopt rule 10b-5. The first reported opinion to cite the rule said that it "was promulgated under section 23(a) of the Securities Exchange Act of 1934."[82] Remarkably, however, the Supreme Court has never cited section 23 in its Rule 10b-5 cases. Instead, it has repeatedly stated, albeit without citing any authority other than itself, that the SEC adopted Rule 10b-5 pursuant to section 10(b) rulemaking power.[83]

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80 *See* 15 U.S.C. § 78n(e).

81 *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 11 n.11 (1985) (discussing rule clause of section 14(e)); *see also* United States v. O'Hagan, 521 U.S. 642, 667 (1997) (Section 14(e) "delegates definitional and prophylactic rulemaking authority to the Commission.").

82 Webster Eisenlohr, Inc. v. Kalodner, 145 F.2d 316, 326 (3d Cir. 1944).

83 *See* Janus Capital Grp., Inc. v. First Derivative Traders, 131 U.S. 2296, 2301 (2011) ("The SEC promulgated Rule 10b-5 pursuant to authority granted under § 10(b) of the Securities Exchange Act of 1934 . . . ."); Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2881 (2010) ("Rule 10b-5 . . . was promulgated under § 10(b)"); *id.* at 2876; The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 592–93 (2001) ("Pursuant to [section 10(b)], the SEC has promulgated Rule 10b-5."); *O'Hagan*, 521 U.S. at 651 ("Pursuant to its § 10(b) rulemaking authority, the Commission has adopted Rule 10b-5 . . . ."); Basic Inc. v. Levinson, 485 U.S.

Rule 10b-5's genesis lies in a quirk of the federal securities statutes. While every security trade has a buyer and a seller, it seems that sellers are more likely to engage in fraud and, accordingly, federal securities regulation generally focuses on sellers' conduct.[84] Thus, until 1942, federal securities law did not generally prohibit securities buyers from engaging in fraudulent conduct. That year, the SEC adopted Rule 10b-5 to prohibit fraud by purchasers of securities. The rule extends the prohibition of deceptive sell-side practices contained in section 17(a) of the Securities Act to buyers of securities.[85] One of the many ironies of Rule 10b-5 is that

224, 230 (1988) ("Pursuant to its authority under § 10(b) of the 1934 Act . . . the Securities and Exchange Commission promulgated Rule 10b-5."); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) ("In 1942, acting pursuant to the power conferred by § 10(b), the Commission promulgated Rule 10b-5 . . . ."); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729 (1975) ("In 1942, acting under the authority granted to it by § 10(b) of the 1934 Act, the Commission promulgated Rule 10b-5 . . . ."); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 318 (2007) ("SEC Rule 10b-5 implements § 10(b) . . . .").

[84] In some sense, the whole point of the Securities Act of 1933 is to require complete candor of those who sell securities to the public. *See Hochfelder*, 425 U.S. at 194 ("The Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities . . . .").

[85] *See* 15 U.S.C. § 77q(a) (2012). While it is well-known that Rule 10b-5 was based on the language of section 17(a) of the Securities Act, *see infra* note 87, a word-by-word comparison shows how little the rule changed preexisting law, and how little it was intended to add to the law. In the following version of Rule 10b-5, language omitted from section 17(a) is shown struck through, and language added is shown in italics. Changes in capitalization are ignored. The subparts are numbered in the statute, while they are lettered in the rule.

> It shall be unlawful for any person ~~in the offer or sale of any securities~~ *directly or indirectly,* by the use of any means or ~~instruments~~ *instrumentality of* ~~transportation or communication in~~ interstate commerce, or ~~by use~~ of the mails~~, directly~~ or ~~indirectly~~ *of any facility of any national securities exchange,*
> (a) To employ any device, scheme, or artifice to defraud,~~ or~~
> (b) To ~~obtain money or property by means of~~ *make* any untrue statement of a material fact or ~~any omission~~ *to omit* to

the courts have created a private action for its violation, but not for a violation of the statutory provision on which it was modeled. The Commission's sole purpose in promulgating the rule was to reach fraud by buyers,[86] and no one involved expected much from it.[87]

> state a material fact necessary in order to make the statements made, in *the* light of the circumstances under which they were made, not misleading~~;~~, or
> (c) To engage in any ~~transaction~~ *act*, practice, or course of business which operates or would operate as a fraud or deceit upon ~~the purchaser~~ *any person, in connection with the purchase or sale of any security.*

86 The original title of the rule was "Employment of manipulative and deceptive devices by any purchaser of a security." *See* Exchange Act Release No. 3230, 7 Fed. Reg. 3804 (May 21, 1942); ("The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."); SEC, EIGHTH ANN. REP. OF THE SEC. AND EXCH. COMM'N 10 (1943) ("During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities, while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers."); Correction, 16 Fed. Reg. 7928-01 (Aug. 11, 1951) ("In the reprint of the rules and regulations under the Securities Exchange Act of 1934, certified on December 15, 1948, and printed at 13 F. R. 8177 et seq., the headnote of § 240.10b-5 should be corrected to read '*Employment of manipulative and deceptive devices*.'" (emphasis supplied)); *cf.* Cady, Roberts & Co., 40 S.E.C. 907, 913 n.22 (1961) ("We note that, in 16 F.R. 7928, August 11, 1951, the Commission struck the words 'by a purchaser' from the title of Rule 10b-5 (then X10B-5) so as to read "Employment of manipulative and deceptive devices."); *id.* at 910 ("Although the primary function of Rule 10b-5 was to extend a remedy to a defrauded seller, the courts and this Commission have held that it is also applicable to a defrauded buyer.").

87 For first-person accounts of the rule's adoption, see 8 LOSS, SELIGMAN & PAREDES, *supra* note 2, at 500; Milton V. Freeman, *Colloquium: Foreword*, 61 FORDHAM L. REV. S1 (1993); ABA Sect. of Corp., Banking & Bus. Law, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 921–23 (1967); Letter from Mayer U. Newfield to Milton V. Freeman, Arnold & Porter (Feb. 8, 1996), *available at*

It was natural for the SEC to turn to section 10(b) to justify the extension of section 17(a) to buyers. While most provisions of the securities laws focus on offers and sales, section 10(b) reaches misconduct "in connection with the pur-purchase or sale" of a security.[88] But section 10(b) was not seen as a particularly important provision of the Exchange Act at the time—indeed it seems never even to have been cited by a court[89]—and the SEC did not rest on section 10(b) alone. When it announced that it was adopting the rule, the SEC said that it was doing so "pursuant to authority conferred upon it by the Securities Exchange Act of 1934, particularly sections 10(b) and 23(a)." Moreover, it parroted the language of section 23(a), when it deemed adoption of the rule "necessary for the exercise of the functions vested in it."[90]

V. DISENTANGLING RULE 10B-5 FROM SECTION 10(B)

The Supreme Court has caused a number of avoidable problems by treating Rule 10b-5 and section 10(b) as coextensive. Consider, for example, the regulation of insider trading under Rule 10b-5. The Supreme Court created the law, and, as it typically does in Rule 10b-5 cases, paid very little attention to the rule in its insider trading cases.[91] The

http://www.sechistorical.org/collection/papers/1990/1996_0208_Newfield_Rule10b5.pdf [hereinafter Newfield Letter]. *See also Blue Chip Stamps*, 421 U.S. at 766–67 (1975) (Blackmun, J., dissenting) (quoting *Conference on Codification*, *supra*, at 922).

88 *See* Newfield Letter, *supra* note 87.

89 The first reported opinion citing section 10(b) was decided in 1944. *See* Baird v. Franklin, 141 F.2d 238 (2d Cir. 1944).

90 Exchange Act Release No. 3230, *supra* note 86. Later, in a compilation of all of its Exchange Act rules (including Rule 10b-5) in the Federal Register, the SEC stated that it adopted all those rules under authority of section 23. 13 Fed. Reg. 8177, 8178 (Dec. 22, 1948).

91 *See* United States v. O'Hagan, 521 U.S. 642, 651–54 (1997); Dirks v. SEC, 463 U.S. 646, 667 (1983); Chiarella v. United States, 445 U.S. 222, 236–37 (1980).

law of insider trading is judicially-created and cannot be learned by reading section 10(b) or Rule 10b-5.[92]

Notwithstanding pressure to clarify the law, Congress has been reluctant to amend the Exchange Act to state clearly when insider trading is illegal, for fear that a statutory definition would amount to a roadmap for fraud, charting ways for informed traders to circumvent prosecution.[93] Of course, this problem is precisely what motivated Congress to give the SEC rulemaking power rather than prohibiting specific conduct by statute. If an SEC rule defining and prohibiting insider trading turned out to permit some troubling practices, the SEC could change its rule much more expeditiously than Congress could amend a statute. However, by ignoring the language of Rule 10b-5 and assuming that any conduct within the scope of section 10(b) is prohibited, the Supreme Court has destroyed any incentive for the SEC to adopt a clear rule. Thus, insider trading is regulated by a rule modeled on the broad and ambiguous language of another statute not tailored to insider trading cases. The rule gives no notice to those trading while in possession of nonpublic information of what is required to trade legally.[94]

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92 *See* Interview by James Stocker with Paul Gonson, SEC Solicitor, SEC Historical Society Oral History Project, 28–29 (Feb. 23, 2011), http://www.sechistorical.org/museum/oral-histories/e-g/ ("Even today, . . . there still is no definition of insider trading in the law or in any SEC rule, but many, many cases on the subject. So really, if you want to know insider trading law you have to go to case books and read those decisions.").

93 *See* H.R. REP. NO. 100-910, at 11 (1988) ("While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee nevertheless declined to include a statutory definition in this bill. . . . [A] statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.").

94 *See O'Hagan*, 521 U.S. at 679 (Scalia, J., dissenting in part) ("While the Court's explanation of the scope of § 10(b) and Rule 10b-5 would be entirely reasonable in some other context, it does not seem to accord with the principle of lenity we apply to criminal statutes (which cannot be mitigated here by the Rule, which is no less ambiguous than the statute)."); *cf.* Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 VA. L. REV. 857, 861 (1984) ("Had Congress wanted to promulgate a prohibition of

The Supreme Court's excessive focus on section 10(b) in deciding Rule 10b-5 cases has impeded the administration of the securities laws, wasted congressional resources, and undermined the public interest. The Court is responsible for this situation and it is uniquely situated to correct it. The solution lies in recognizing distinctions between private and public enforcement of Rule 10b-5.

With respect to private enforcement, the Supreme Court should openly embrace its unavoidable primacy as lawmaker. *Someone* must make the law governing private litigation under Rule 10b-5. The statute says relatively little on the subject and, while Congress occasionally amends the Exchange Act to govern private actions under the rule,[95] ultimately courts must set most of the rules for private litigation under Rule 10b-5. The Court has acknowledged as much, and has candidly looked beyond the language of section 10(b) in refining the elements of the private cause of action for violations of the rule, as opposed to determining the conduct prohibited by the rule, which section 10(b) controls.[96] Notwithstanding the Court's poor record of reading the Exchange Act, it should go further and reconsider the wisdom of some of the private litigation it has created itself.

With respect to public enforcement, the Court should be more cautious. The statute addresses public enforcement in great detail. The fact that courts need to develop law for private litigation under Rule 10b-5 does not require or justify applying that law to actions brought by the SEC. On the contrary, fidelity to the Exchange Act requires that the Court explicitly limit its decisions in private actions to en-

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such generality [as Rule 10b-5], it could have done so and eliminate [sic] the intermediate requirement of a Commission regulation.").

95 The primary example is the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat 737 (codified in Securities Act §§ 11, 12, 20, 27, 27A; Exchange Act §§ 10A, 15, 20, 21, 21D, 21E.

96 *See* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2881 n.5 (2010); *id.* at 2888–90 (Stevens, J., concurring in judgment); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 172–73 (1994); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, . . . we consider . . . what may be described as policy considerations . . . .").

sure that the law governing private actions is not applied to cases initiated by the SEC.

This Part shows how a more careful regard for the statute and the rule can help rationalize the enforcement and administration of the securities laws. The reflexive use of section 10(b) to determine the contours of private actions under Rule 10b-5 has created the fraud on the market class action and its attendant problems, and the Supreme Court should revisit those actions. Congress has repeatedly rejected extension of the Court's restrictive section 10(b) cases to the SEC, implicitly rejecting the Court's approach to the statute as well. In the context of longstanding and noncontroversial SEC regulation of trading practices, the Court's interpretation of section 10(b) is not consistent with the language, structure, or history of the Exchange Act.

A. Section 10(b) and Private Actions: Fraud on the Market

The most costly and consequential private cases under Rule 10b-5 are so-called fraud on the market class actions. In these cases, securities traders seek to recover their trading losses from corporate security issuers that made false statements that affected market prices, even though the corporate defendants did not themselves buy or sell the securities.[97] These cases constitute the great bulk of shareholder claims litigated in federal courts. Public companies have "roughly a two percent chance of being sued in a securities class action in any given year."[98] These cases are extraordinarily disruptive and expensive to litigate, and commenta-

97 *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1312 (2008) ("[T]he prototypical Rule 10b-5 case [has become] a class action brought on behalf of thousands of investors, based on misstatements or omissions made in public disclosure documents that most class members never read, against a deep-pocketed corporate defendant that did not itself profit from the fraud.").

98 TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 22 (2010).

tors have grown increasingly critical of their cost and failure to advance the interests of investors or the public at large.[99]

Fraud on the market actions rest on a very thin statutory reed (or read).[100] Until 1968, it seemed clear that Rule 10b-5 did not reach a non-trading corporation that made false statements about its operations. Then, in *SEC v. Texas Gulf Sulphur Co.*[101] the Second Circuit said it did. That result, the court explained, followed from the language of section 10(b). Section 10(b) reaches conduct "in connection with" a security trade, while other antifraud provisions reach only those who "offer or sell a security by means of" false statements,[102] or employ false statements "in the offer or sale of any securities."[103] These distinctions, the court concluded, "demonstrate that when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear."[104]

Texas Gulf Sulphur was an extremely important and controversial case, but its implications for non-trading issuers were limited. It permitted the SEC to pursue them, but the monetary sanctions from government litigation were almost never ruinous. It did not substantially increase the risk of private litigation, since private claimants still had to show that they had relied upon and been damaged by issuer false

99 *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 72 (2011) ("The fraud-on-the-market . . . cause of action just doesn't work. At least that is the consensus view among academics respecting the primary class action vehicle under the federal securities laws."); John C. Coffee, Jr., *Reforming the Securities Class Action*, 106 COLUM. L. REV. 1534 (2006); Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151 (2009); Rose, *supra* note 97; Richard B. Stewart & Cass R. Sunstein, *Public Programs and Private Rights*, 95 HARV. L. REV. 1193, 1303–04 (1982).

100 *See* Merritt Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 246 n.16 (2009); Merritt Fox, *Securities Class Actions Against Foreign Issuers*, 64 STAN. L. REV. 1173, 1186–90 (2012).

101 401 F.2d 833 (2d Cir. 1968) (en banc).

102 15 U.S.C. § 77*l*(a)(2) (2012).

103 *See id.* § 77q(a).

104 *Texas Gulf Sulphur*, 401 F.2d at 860.

statements. This requirement made it an expensive strategy to pursue in private litigation and made class actions impracticable. In 1988, however, the Supreme Court's decision in *Basic Inc. v. Levinson* changed the implications for non-trading issuers. That decision allowed plaintiffs in some circumstances to satisfy the reliance requirement in private actions by establishing that the issuer's false statements affected the market price of its securities.[105] By permitting a presumption of reliance to substitute for individualized investor proof, *Basic* made class actions practicable. Since then, "[t]ens of billions of dollars have changed hands in settlements of 10b-5 lawsuits . . . as a result of *Basic*."[106]

The Supreme Court certainly knew that it was effectively enabling private class actions in *Basic*, but, remarkably, the majority did not even mention that its decision would impose substantial liability on public companies that were not themselves trading.[107] *Texas Gulf Sulphur* may have been rightly decided, but, as Judge Friendly emphasized in his concurrence, the decision to permit the SEC to pursue a non-

105 *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988). As the Court noted, some lower courts had already accepted the fraud on the market theory. *See id.* at 229–30.

106 Langevoort, *supra* note 99, at 152.

107 The closest the majority came to even recognizing that it was allowing actions against non-trading defendants was in a footnote in another part of its opinion dealing with the definition of materiality: "We find no authority in the statute, the legislative history, or our previous decisions for varying the standard of materiality depending on who brings the action or whether insiders are alleged to have profited." 485 U.S. at 240 n.18. The dissenters in *Basic*, in contrast, were concerned with the likely consequences of the decision. *See id.* at 250–51 (White, J., dissenting) ("[T]he fraud-on-the-market theory is a mere babe. Yet today, the Court embraces this theory with the sweeping confidence usually reserved for more mature legal doctrines. In so doing, I fear that the Court's decision may have many adverse, unintended effects as it is applied and interpreted in the years to come."). The Court has expressed similar sentiments in decisions restricting the private right of action for violations of Rule 10b-5. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 189 (1994); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739, 747–48 (1975).

trading company did not lead, ineluctably, to the conclusion that securities traders should be permitted to shift their losses to the non-trading issuer of those securities, and, indirectly, to its non-trading shareholders (none of whom profited from the misrepresentation).[108] Given the implications of fraud on the market class actions and the substantial criticism they have engendered, their value should be reexamined by someone with power to regulate them. Congress could do so, but it is difficult to enact legislation, and the failure of Congress to reverse *Basic* hardly shows that Congress would have created private class actions against non-trading issuers itself.[109] On the contrary, it is hard to imagine that any American Congress would ever have created such actions,[110] and it is certain that no Congress would do it knowing what fraud on the market actions have wrought. Fraud on the market class actions are entirely the creation of the Supreme Court. The problems they engender might have been avoided if the Court had asked in *Basic* whether the scope of Rule 10b-5—or section 10(b)—is the same in pri-

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108 *See* 401 F.2d at 866 ("[W]e should explicate more clearly why, despite the principle that a violation of the securities laws or regulations generally gives rise to a private claim for damages, violation of Rule 10b-5(2) may not do so under all circumstances . . . ." (citation omitted)); *see also id.* at 867 ("If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the fact–all judged in the bright gleam of hindsight–will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.").

109 *See* Bratton & Wachter, *supra* note 99, at 133–47 (discussing impediments to legislative reform of fraud on the market); *see also* William N. Eskridge, *Interpreting Legislative Inaction*, 87 MICH. L. REV. 67, 67 (1988) (addressing "longstanding debate in the theory of statutory interpretation over what meaning, if any, can be attributed to the legislature's failure to do something.").

110 15 U.S.C. § 78r (2012) provides a private right of action against issuers that make false or misleading statements in SEC filings. However, because it has a limited scope and imposes substantial limitations and conditions, only a few cases have been brought under it. *See* 9 LOSS, SELIGMAN & PAREDES, *supra* note 2, at 363–68.

vate and SEC actions. Inasmuch as it didn't, it should resolve the *Basic* problem now. Although the Court may be reluctant to undertake the overtly political task of limiting private rights of action on the basis of its own policy prefer-preferences,[111] both the private right of action and the *Basic* fraud on the market class action are judicial creations.

It would no doubt be difficult for any court to determine the social value of fraud on the market litigation within the confines of the judicial process in a particular case, and the question involves political considerations and financial questions that may exceed judicial competence. This might suggest that the SEC should address the *Basic* question through rulemaking, inasmuch as it may have greater technical competence and political legitimacy than the courts in this context. Academic commentators have also argued that the SEC should play a greater role in policing the contours of the private right of action under Rule 10b-5.[112] The Court, however, has been remarkably hostile to the SEC's opinions on section 10(b) generally, and on the private right of action particularly, and has shown the Commission little, if any, deference.[113]

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111 *See* Girardeau A. Spann, *Teaching Constitutional Law*, 49 ST. LOUIS U.L.J. 709, 715 (2005).

112 *See* Bratton & Wachter, *supra* note 99, at 147–67 (proposing that the SEC remove, by rule, the presumption of reliance); Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963 (1994) (proposing that the SEC consider disimplying the private right of action under Rule 10b-5); Rose, *supra* note 97 (proposing that the SEC be empowered to determine when Rule 10b-5 class actions may be filed).

113 As the Court recently summarized in Janus Capital Grp., Inc. v. First Derivative Traders, 131 S.Ct. 2296, 2303 n.8 (2011) (parallel citations omitted):

> [W]e have previously expressed skepticism over the degree to which the SEC should receive deference regarding the private right of action. *See* Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 41, n.27 (1977) (noting that the SEC's presumed expertise "is of limited value" when analyzing "whether a cause of action should be implied by judicial interpretation in favor of a particular class of litigants"). This also is not the first time this Court has disagreed with

The Court's position seems jarring in the age of *Chevron,*[114] but it is largely consistent with the scheme of the Exchange Act. The Exchange Act does give the SEC authority to make rules carrying the force of law, and Rule 10b-5 is such a rule.[115] However, the SEC has a minimal role with respect to section 10(b). Moreover, the Exchange Act provides clear and unambiguous remedies for violations of the Act and the SEC's rules, and nothing in the Exchange Act suggests that Congress authorized the SEC to change those remedies[116] or create a private right of action for violation of its rules. However much authority the SEC has to implement the Exchange Act, the Act does not authorize the SEC to tinker with the judicially created private right of action.[117]

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the SEC's broad view of § 10(b) or Rule 10b-5. *See, e.g.*, Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A., 511 U.S. 164, 188–191(1994); Dirks v. SEC, 463 U.S. 646, 666, n.27 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 746, n.10 (1975).

114 Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984).

115 *See* United States v. Mead Corp., 533 U.S. 218, 226–27 (2001).

116 *Cf.* Gabelli v. SEC, 133 S.Ct. 1216 (2013) (holding that the limitation period of 28 U.S.C. § 2462 (2006) applies to SEC civil penalty actions, without discussing deference). Judicial hostility to the SEC's attempts to determine the parameters of private actions established by the securities statutes is evident in recent decisions rejecting Securities Act Rule 159A, 17 C.F.R. § 230.159A (2013), which defines the word "seller" in section 12(a)(2) of the Securities Act, 15 U.S.C. § 77*l*(a)(2) (2012), a statutory private remedy, to include issuers in firm commitment underwritings. *See* Maine State Ret. Sys. v. Countrywide Fin. Corp., No. 2:10-CV-0302 MRP (MANx), 2011 WL 4389689, at *10 (C.D. Cal. May 5, 2011) ("The Court therefore concludes that, regardless of what the SEC's position may be, Plaintiffs must allege direct solicitation."); *see also* Capital Ventures Int'l v. UBS Sec. LLC, No. 11-11937-DJC, 2012 WL 4469101, at *14 n.9 (D. Mass. Sept. 28, 2012); Mass. Mut. Life Ins. Co. v. Residential Funding Co., LLC, 843 F.Supp. 2d 191, 207 (D. Mass. 2012). The courts might have simply noted that Rule 159A is a nullity, inasmuch as the word "seller," which the SEC defined in the rule, does not appear in section 12.

117 *Cf.* Adams Fruit Co. v. Barrett, 494 U.S. 638, 649 (1990) ("[E]ven if [the Migrant and Seasonal Agricultural Worker Protection Act's] language establishing a private right of action is ambiguous, we need not defer to the Secretary of Labor's view of the scope of [29 U.S.C.] § 1854 because

B. Section 10(b) and SEC Power

Just as *Texas Gulf Sulphur*'s expansive reading of section 10(b) in SEC actions led to problems when it was extended to private actions in *Basic*, extending a narrow construction adopted in private actions to SEC actions can complicate the administration of the Exchange Act and undermine the public interest. When the Supreme Court construes section 10(b) to constrain private litigation under Rule 10b-5, it almost inevitably must also constrain the SEC's enforcement actions.[118] Thus, four years after deciding *Ernst & Ernst v. Hochfelder*,[119] the Court said that the SEC also had to prove

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Congress has expressly established the Judiciary and not the Department of Labor as the adjudicator of private rights of action arising under the statute. A precondition to deference under *Chevron* is a congressional delegation of administrative authority.").

Professor and former SEC Commissioner Joseph Grundfest has forcefully argued that the SEC has the authority to "disimply" the private right of action under Rule 10b-5. *See* Grundfest, *supra* note 112, at 976. His argument rests on the incorrect reading of section 10(b) as a delegation of rulemaking authority. *See id.* at 977 ("The logic in support of disimplication is simple. Section 10(b) is, by its terms, nothing more than a congressional delegation of authority to the Commission to adopt antifraud 'rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.'"). Professors Bratton & Wachter also suggest that the SEC has the power to limit private actions under Rule 10b-5, although they acknowledge it may not. *See supra* note 99, at 165. Their argument follows Grundfest's (although they characterize his article as only "failing to see any legal obstacle to the Commission's ability to disimply private rights of action," *id.* at 165 n.367), and is premised on the same misreading of section 10(b). *See id.* at 165 ("In our view, the SEC has the power to remove the FOTM presumption via rulemaking. The authority follows from the words of section 10(b), which delegates authority to make such antifraud 'rules and regulations as the Commission may prescribe . . . .'").

118 The Court's private-action decisions are frequently discussed by student notes addressing the division of lower courts on the question of whether those decisions govern government enforcement actions. *See* David He, Note, *Beyond Securities Fraud: the Territorial Reach of U.S. Laws After* Morrison v. N.A.B., 2013 COLUM. BUS. L. REV. 148; Matthew P. Wynne, Note, *Rule 10b-5(b) Enforcement Actions in Light of* Janus: *Making the Case for Agency Deference*, 81 FORDHAM L. REV. 2111 (2013).

119 425 U.S. 185 (1976).

scienter in its Rule 10b-5 cases, explaining that "the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought."[120]

Supreme Court decisions that require scienter for Rule 10b-5 actions may have been good ones. The "manipulative or deceptive device or contrivance" language of section 10(b) can be read to restrict the section to misconduct, and that reading is almost certainly correct in the context of a criminal case.[121] The question of intent in private actions is one for the courts, and the holding in *Hochfelder* can be justified on policy grounds. The Court's extension of the requirement to the SEC cannot be justified by the reading of the statute offered here, but some heightened intent may be required in order for the SEC to secure an injunction against further violations anyway.[122] In any event, the SEC can reach most of the conduct covered by Rule 10b-5 under section 17(a) of the Securities Act without proving scienter.

The history of *Hochfelder* notwithstanding, Congress has repeatedly rejected the extension of the Court's restrictive section 10(b) cases to the SEC. Congress is apparently quite comfortable with allowing the SEC to forbid and sanction conduct that private parties cannot challenge. From the legislative perspective, it is usually a bad idea to use section 10(b) to limit the power of the SEC.

For example, in *Central Bank of Denver v. First Interstate Bank of Denver*,[123] the Court held that a private action under Rule 10b-5 is not available against those who aid and abet the violation. The Court's emphasis on the language of section 10(b) suggested that the SEC would not be able to en-

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120 Aaron v. SEC, 446 U.S. 680, 691 (1980).

121 15 U.S.C. §§ 78m(a), 78n(a).

122 *See* SEC v. Unifund SAL, 910 F.2d 1028, 1040 (2d Cir. 1990) (to obtain an injunction against further violations, SEC must "make a substantial showing of likelihood of success as to both a current violation and the risk of repetition.").

123 511 U.S. 164 (1994).

force the rule against aiders and abettors either.[124] Congress promptly responded by adding section 20(e) to the Exchange Act, which now provides that in an SEC action for an injunction, "any person that knowingly or recklessly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided."[125]

Similarly, soon after the Supreme Court limited the extraterritorial reach of section 10(b) in *Morrison v. National Australia Bank Ltd.*,[126] Congress amended section 27 of the Exchange Act[127] to provide that the courts have jurisdiction in actions brought by the SEC or the United States involving conduct outside the United States that has a foreseeable substantial effect within the United States.[128]

Congress has rejected some of the Court's other section 10(b) cases more subtly. Notwithstanding considerable pressure to do so, it did not overturn the Court's retrograde in-

124 *See* 511 U.S. at 200 (Stevens, J., dissenting) ("The majority leaves little doubt that the Exchange Act does not even permit the SEC to pursue aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b-5.").

125 15 U.S.C. § 78t(e); *see* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104 (adding section 20(e)); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929O (2010) (amending section 20(e) to reach reckless behavior); *cf.* 15 U.S.C. § 78u-2(a) (providing administrative penalties for willfully aiding or abetting violation).

126 130 S. Ct. 2869 (2010).

127 15 U.S.C. § 78aa; *see* Dodd-Frank Act § 929O (amending section 27). This amendment was as clumsy as many of the Supreme Court's Rule 10b-5 cases. *See* Adam Pritchard, *Securities Law in the Roberts Court: Agenda or Indifference*, 37 J. Corp. L. 105, 134–35 (2011). It provides that courts will have jurisdiction of government-initiated cases, even though in *Morrison* Justice Scalia emphasized that the decision was on the reach of section 10(b), not on the jurisdiction of courts. *See* 130 S. Ct. at 2877.

128 *See* SEC v. Tourre, No. 10 Civ. 3229 (KBF), 2013 WL 2407172, at *1 n.4 (S.D.N.Y. June 4, 2013) ("[T]he Dodd-Frank Act effectively reversed *Morrison* in the context of SEC enforcement actions.").

sider trading decision in *Dirks v. SEC*.[129] Instead, Congress sought to limit the decision's implications and reinforce the nascent misappropriation theory in an unusual way—through statutory findings stating that the SEC's rules governing trading while in possession of material, non-public information were, as required by the Exchange Act, necessary and appropriate, and that the SEC had enforced them effectively and fairly.[130]

The Court created a less tractable problem with its interpretation of the term "manipulative" in section 10(b). Another irony of the ascendancy of Rule 10b-5 is that the Exchange Act was probably motivated more by concern about manipulative practices than about fraud and deception,[131] and the SEC's regulation of manipulation is an important, if less well-known, part of its work. However, without any attention to that regulation, and in a series of cases that involved conduct that no one familiar with the securities markets would think had anything to do with manipulation, the Court explained the Exchange Act in a way that undermined the SEC's regulatory authority.

In bringing criminal manipulation cases, the government typically focuses on defendants who have engaged in so much deceptive behavior beyond trading that it can prove deception without arguing that trading practices were "manipulative."[132] In the regulatory context, however, the focus

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129 463 U.S. 646 (1983).

130 *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 2(1), 102 Stat. 4677 (findings appended to 15 U.S.C. § 78u-1); *see also* United States v. O'Hagan, 521 U.S. 642, 666 n.11 (1997) ("The United States additionally argues that Congress confirmed the validity of the misappropriation theory in the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), § 2(1), 102 Stat. 4677, note following 15 U.S.C. § 78u-1. . . . Because we uphold the misappropriation theory on the basis of § 10(b) itself, we do not address ITSFEA's significance for cases of this genre."); Steve Thel, *Statutory Findings and the Regulation of Insider Trading*, 50 VAND. L. REV. 1091 (1997).

131 *See* 15 U.S.C. § 78b(3)–(4) (necessity for regulation); Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) ("The 1934 Act was designed to protect investors against manipulation of stock prices.").

132 *See* United States v. Offill, 666 F.3d 168 (4th Cir. 2011).

is often on trading alone. Recall, for example, the trading practice rules of Regulation M, which regulate trading in connection with public offerings.[133] One of the regulated practices is stabilization, in which those making a public offering buy securities during the offering to avoid disrupting the market and causing a temporary price decline. Regulation M permits stabilization, but only under certain conditions.[134]

The SEC's trading practice rules, including Regulation M, are fundamental, technical securities regulations. They are exactly the sort of rules that the Exchange Act contemplates—far more so than a rule like 10b-5. Indeed, it can fairly be said that Congress created the SEC so that it would adopt rules like these. The Exchange Act clearly contemplates SEC regulation of trading practices. Section 9(a)(6) makes it unlawful to effect transactions for the purpose of stabilizing security prices in contravention of SEC rules,[135] and section 10(a) makes it unlawful to effect short sales in contravention of SEC rules.[136] However, until they were amended in 2010, these provisions reached only transactions in securities registered on a securities exchange. Under the Supreme Court's stilted reading of SEC rulemaking power, the SEC could regulate stabilization and short sales of over-the-counter securities only if those practices are "manipulative" within the meaning of section 10(b).[137] However, the Supreme Court's section 10(b) cases suggest that they are not.

In *Hochfelder*, the Court reinforced its conclusion that section 10(b) requires scienter by interpreting "manipula-

133 *See supra* notes 56–58 and accompanying text.

134 *See* Regulation M Rules 101–104, 17 C.F.R. §§ 242.101–04 (2013).

135 15 U.S.C. § 78i(a)(6).

136 *See id.* § 78j(a).

137 SEC Rule 10b-1, 17 C.F.R. § 240.10b-1 (purporting to extend section 9(a) to all securities exempt from registration by defining the term "manipulative or deceptive device or contrivance" in section 10(b)). Under the Court's conception of section 10(b), however, many of the practices prohibited by section 9(a) are not "manipulative" and the SEC has no authority to define "manipulative" in section 10(b).

tive" narrowly, suggesting that the word covers only a subset of fraudulent conduct.[138] In particular, it said that "[u]se of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[139]

The Court's discussion of the word "manipulative" in *Hochfelder* might have been treated as dicta. However, under its practice of deciding Rule 10b-5 cases by focusing on the language of section 10(b), the Court had to confront the meaning of "manipulative" directly in *Santa Fe Industries v. Green.*[140] The plaintiff there challenged a short-form merger under Rule 10b-5, arguing that the majority shareholder had caused minority shareholders to be cashed out at an inadequate price in violation of its fiduciary duties. The Second Circuit allowed the case to proceed, holding that Rule 10b-5 did not require deception.[141] Thus, to decide the case, the

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138 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) ("The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10 (b) was intended to proscribe knowing or intentional misconduct."); *see id.* at 199 ("The argument simply ignores the use of the words 'manipulative,' 'device,' and 'contrivance' terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.").

139 *Id.* at 197; *id.* at 203 (During committee discussion of what became section 10(b), a spokesman for the drafters described it "rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.' It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions. Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing 'manipulative (or cunning) devices' to include negligence."); *see also id.* at 199 n.21 ("Webster's International Dictionary . . . defines 'manipulate' as 'to manage or treat artfully or fraudulently; as to Manipulate accounts . . . . 4. *Exchanges.* To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . .; to rig.'" (first ellipsis added)).

140 430 U.S. 462 (1977).

141 Green v. Santa Fe Indus., 533 F.2d 1283, 1287 (2d Cir. 1976), *rev'd*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

Court had to determine whether the challenged conduct was "manipulative" even if it was not deceptive.

In *Santa Fe*, the Court quoted essentially everything it had said in *Hochfelder* that suggested that "manipulative" practices are a subset of "deceptive" ones.[142] The Court then concluded that "section 10(b)'s general prohibition of practices deemed by the SEC to be 'manipulative'—in this technical sense of artificially affecting market activity in order to mislead investors—is fully consistent with the fundamental purpose of the 1934 Act . . . ."[143] Thus, after *Santa Fe*, it appeared that a practice could not be "manipulative" within the meaning of section 10(b) unless it was designed to mislead investors. Finally, a few years later, in a case arising under section 14(e) of the Exchange Act,[144] which forbids the use of manipulative or deceptive devices in connection with tender offers, the Court read *Hochfelder* to hold that in section 10(b) the word "manipulative" means "conduct designed to deceive or defraud investors."[145]

Nothing in this Article suggests that the plaintiffs should have prevailed in any of these cases. However, by finding that the results in *Hochfelder* and *Santa Fe* were required by the language of section 10(b), and repeatedly holding that the SEC's regulatory power is defined by that language,[146] the Court suggested that the SEC cannot regulate manipulative trading practices unless those practices are inherently misleading or designed to mislead investors. Lower courts in private litigation have read the cases to mean that securities trading alone cannot be manipulative within the meaning of section 10(b) and have required private plaintiffs to show some sort of deception beyond trading.[147]

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142 *See Santa Fe*, 430 U.S. at 476–77.

143 *Id.*

144 15 U.S.C. § 78n(e) (2012).

145 *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 6 (1985). The Court also held that the word "manipulative" in section 14(e) "requires misrepresentation or nondisclosure." *Id.* at 12.

146 *See supra* text accompanying notes 15–17.

147 *See, e.g.*, GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 204–05 (3d Cir. 2001) ("[M]arket manipulation generally refers to practices,

The SEC's stabilization rules have always been understood to be an appropriate response to manipulation—recall that they were formerly part of the series of 10b rules.[148] But if conduct is manipulative only if it is deceptive or designed to mislead investors, it is difficult to argue that stabilization, short selling, and other trading practices are manipulative (at least as the Court has defined the term). Stabilizing trades are real and reported trades. Plans for stabilization are fully disclosed in offering documents, and stabilization may work best when disclosed, so that potential purchasers will not be concerned about market disruptions. Whether or not they are appropriate, stabilizing transactions are not deceptive. Similarly, short-sale regulation has a long pedigree, but short sales are not deceptive, regardless of their value.

Surely the SEC has always had power to regulate stabilization, short selling, and other manipulative trading practices, notwithstanding the Supreme Court's Rule 10b-5 cases, although those cases may have led the Commission to abandon the 10(b) designation when it replaced its old trading rules with Regulation M.[149] Nevertheless, in 2010, in an unheralded provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress amended section 9(a)(6) of the Exchange Act, which had previously applied only to exchange-registered securities, to make it unlawful to affect stabilizing transactions in "any security other than a government security" in contravention of SEC rules.[150] It al-

such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.") (internal quotation marks removed); Sullivan & Long, Inc. v. Scattered Corp., 47 F.3d 857, 865 (7th Cir. 1995) ("Deception there was not; and most forms of 'manipulation' involve deception in one form or another."); Jag Media Holdings, Inc. v. A.G. Edwards & Sons, Inc., 387 F.Supp. 2d 691, 708 (S.D. Tex. 2004); Jones v. Intelli-Check, Inc., 274 F.Supp. 2d 615, 624 (D.N.J. 2003).

148 *See supra* text accompanying note 57.

149 17 C.F.R. §§ 242.200–03 (2013); *see supra* text accompanying note 57.

150 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929L (amending Exchange Act § 9(a)(6), 15 U.S.C. § 78i(a)(6) (2012)).

so amended the rest of section 9(a) and section 10(a) to extend them to all securities other than government securities.[151] The amendments were necessary only because the understanding of regulatory authority that the Supreme Court has expressed in its section 10(b) cases is inconsistent with the regulatory and rulemaking structure of the Exchange Act and left the validity of the SEC's longstanding regulation of trading practices in question.

VI. CONCLUSION

The Supreme Court has determined the scope of federal securities regulation in a series of cases in which it has read section 10(b) of the Securities Exchange Act as either prohibiting certain misconduct or authorizing the SEC to regulate that conduct and only that conduct. The Court's reading is wrong. Section 10(b) does not prohibit anything, and it neither grants the SEC rulemaking power nor limits its rulemaking power under the Exchange Act. Judging by the language, structure, and history of the Exchange Act, section 10(b) simply triggers criminal sanctions for certain rule violations. This is an important function, but very different from the one the Supreme Court has ascribed to section 10(b).

151 *See* 15 U.S.C. §§ 762(d)(2), 929L (amending 15 U.S.C. § 78i(a) (Supp. V 2011)); see *id.* § 929L(2) (amending 15 U.S.C. § 78j(a)).