Fordham Law Review

Volume 85 | Issue 1 Article 9

2016

Securities and Financial Regulation in the Second Circuit

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SECURITIES AND FINANCIAL REGULATION IN THE SECOND CIRCUIT

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INTRODUCTION

The Second Circuit has long been the country's preeminent court in the field of securities and financial regulation.[1] Since the passage of the Securities Act of 1933 ("the Securities Act") and the Securities Exchange Act of 1934 ("the Exchange Act"), the Second Circuit has been the leading interpreter of U.S. securities laws and arguably the most influential court in the area of securities regulation in the world. From 1961 to 1978, the Second Circuit produced nearly five times as many securities law opinions as the average federal appellate court; the Second Circuit alone was responsible for one-third of all securities opinions issued by appellate courts.[2] Particularly, the Second Circuit handed down up to 70 percent of the opinions that appear in securities law casebooks covering the same period.[3] It is little wonder, then, that the Supreme Court frequently has called the Second Circuit the "Mother Court" in the area of securities.[4]

The Second Circuit's influence in the realm of securities goes beyond pure numbers. The court's membership has included several celebrated judges who have been particularly influential in the field of securities regulation, among them Learned Hand and Henry Friendly. According to some, Judge Friendly did more to influence the law of securities regulation

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1. *See* JEFFREY B. MORRIS, FEDERAL JUSTICE IN THE SECOND CIRCUIT: A HISTORY OF UNITED STATES COURTS IN NEW YORK, CONNECTICUT & VERMONT 1787–1987, at 151 (1987).

2. *See* Margaret V. Sachs, *Judge Friendly and the Law of Securities Regulation: The Creation of a Judicial Reputation*, 50 SMU L. REV. 777, 792 (1997).

3. *See id.* at 793.

4. Morrison v. Nat'l Austl. Bank, 561 U.S. 247, 275–76 (2010) (Stevens, J., concurring in judgment) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975)). Indeed, in a recent book, Justice Stephen Breyer comments that securities cases emanating from the Second Circuit have "had considerable influence, because the legal community has long thought that the Second Circuit . . . understood securities law and securities markets especially well." STEPHEN BREYER, THE COURT AND THE WORLD: AMERICAN LAW AND THE NEW GLOBAL REALITIES 115 (2015).

than any other judge in U.S. history.[5] The reputation of the Second Circuit in the realm of securities has been so great that other courts, including the Supreme Court, often mention by name the particular judges that decided a given Second Circuit precedent to justify their reliance on that decision.[6] And many courts have long looked to its jurisprudence for guidance in deciding novel or complex securities law issues.

Several factors may explain the Second Circuit's distinctive influence in these fields. The Second Circuit has a distinct geographic advantage: its jurisdiction includes New York City, home to the largest securities market in the world. Another factor at play is the sophisticated bar, including both government lawyers and private practitioners that practice in the circuit. Indeed, some leading securities lawyers—for example, Jerome Frank, a one-time chairman of the Securities and Exchange Commission—have sat on the Second Circuit bench.

Given its preeminence in this field, the Second Circuit has often been the court to pave new ground in the realm of securities law. It was the first appellate court to recognize a private cause of action under Rule 10b-5.[7] It was one of the first courts to create liability under that rule for trading on nonpublic information.[8] And a landmark ruling in 2014 limiting "tippee liability" in insider trading cases came from the Second Circuit.[9] These innovations, which continue to this day, have gone a long way toward establishing the Second Circuit as the vanguard of the federal appellate courts in the field of securities.

I. DEVELOPING ROBUST CIVIL ENFORCEMENT MECHANISMS FOR THE SECURITIES LAWS

The following sections track the Second Circuit's significant role in developing civil enforcement mechanisms for federal securities laws, including taking the lead in defining the scope of SEC enforcement actions and private rights of actions.

A. New Securities Laws Passed During the New Deal

In the throes of the Great Depression and informed by lessons of the stock market crash of October 1929, Congress passed the Securities Act and

5. *See Morrison*, 561 U.S. at 275–76 (Stevens, J., concurring) (quoting Louis Loss, *In Memoriam: Henry J. Friendly*, 99 HARV. L. REV. 1722, 1723 (1986)); Sachs, *supra* note 2, at 780–81. Indeed, Friendly's name is invoked in ten securities opinions of the U.S. Supreme Court and in over three hundred securities opinions outside of the Second Circuit. Sachs, *supra* note 2, at 781.

6. *See, e.g.*, *Morrison*, 561 U.S. at 275 (Stevens, J., concurring); Basic Inc. v. Levinson, 485 U.S. 224, 238–39 (1988); *Blue Chip Stamps*, 421 U.S. at 723; Fulton Cty. Emps. Ret. Sys. v. MGIC Inv. Corp., 675 F.3d 1047, 1050 (7th Cir. 2012); Liberty Prop. Trust v. Republic Props. Corp., 577 F.3d 335, 342 (D.C. Cir. 2009) (Randolph, J., dissenting).

7. *See Blue Chip Stamps*, 421 U.S. at 730.

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

9. *See* United States v. Newman, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015).

the Exchange Act.[10] The Exchange Act created the Securities and Exchange Commission (SEC) and gave it the mission of enforcing new securities laws created to restore investor confidence in U.S. capital markets.[11] From their inception, the SEC and these new securities laws were controversial.[12] Contemporary critics raised questions about the constitutionality of these new laws.[13] But the SEC successfully withstood these tests, and its enforcement authority quickly became a powerful tool. With it, the Second Circuit became an important forum for litigating enforcement actions.

One of the first of such actions, *Charles Hughes & Co. v. SEC*,[14] helped redefine the relationship between broker-dealers and their customers. The SEC found that Charles Hughes, a registered broker-dealer firm, sold securities well above their market prices without disclosing this fact to its customers (primarily homemakers and widows).[15] The SEC revoked Charles Hughes's broker-dealer registration.[16] Hughes challenged that decision on several grounds, including that the SEC did not have sufficient evidence to prove a violation of the securities laws.[17] Though the Second Circuit conceded that there was minimal evidence that he actually made false statements to its customers, the court affirmed the penalty, concluding that Hughes's fraud consisted of its failure to disclose the large markup it added to market prices.[18] The court reasoned that broker-dealers "hold[]

10. The acts were informed by a report of the Senate Committee on Banking and Currency that described the abuses in the securities markets. The report attributed the stock market crash to many of these abuses. Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 215–17 (1959); *see also* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) ("[The Senate Banking and Currency Committee] spread on the record more than the peccadillos of groups of men involved in the issuance and marketing of securities. It indicted a system as a whole that had failed miserably . . . .").

11. 15 U.S.C. §§ 78d(a), 78n(a) (2012); Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 329–30 ("These new securities laws were among the many Roosevelt Administration efforts to stimulate the economy and restore confidence in the capitalist system.").

12. Milton V. Freeman, *A Private Practitioner's View of the Development of the Securities and Exchange Commission*, 28 GEO. WASH. L. REV. 18, 1819 ("When the SEC was established in 1934 . . . there was no real acceptance of the [acts] in the financial community. . . . In the earlier years there was substantial dispute between the [SEC] on the one hand, and the New York Stock Exchange and the investment banking industry on the other.").

13. Keller & Gehlmann, *supra* note 11, at 337. *See generally* Jacob Lippman, *Constitutionality of the Securities Exchange Act of 1934*, 9 ST. JOHN'S L. REV. 1 (1934) (discussing the constitutionality of the Securities Act and the SEC's authority). The SEC's perceived legitimacy was not aided by the appointment of Joseph Kennedy to the Commission, as he may have made much of his fortune through market manipulation and insider trading. Keller & Gehlmann, *supra* note 11, at 348. Roosevelt jokingly adopted the motto "it-takes-a-thief-to-catch-a-thief." *Id.*

14. 139 F.2d 434 (2d Cir. 1943).

15. *Id.* at 436.

16. *See id.*

17. *See id.*

18. *See id.*

[themselves] out as competent to advise" and that "in view of [their] expert knowledge . . . [were under a duty] not to take advantage of its customers' ignorance of market conditions."[19] In so holding, the Second Circuit was the first court to adopt the SEC's "shingle theory"—the theory that broker-dealers, simply by virtue of their position, make an implied representation to customers that they will be dealt with fairly.[20] The SEC later expanded this theory and applied it in a number of cases, bringing actions against broker-dealers for "churning" (a practice of trading stocks repeatedly in a client's account to generate more commissions), high-pressure sales tactics, and failing to disclose conflicts of interest, among others.[21]

Charles Hughes also set the stage for Judge Charles Clark's widely cited dissent in *Baird v. Franklin*.[22] The suit in *Baird* resulted from a scandal involving the Wall Street giant Richard Whitney, the wealthy and well-connected president of the New York Stock Exchange (NYSE).[23] Whitney had been hailed as the "Great White Knight" of Wall Street during the 1929 market crash when he bought shares of blue-chip stocks as the market fell—helping eventually to stabilize the market and end the crash.[24] As president of the country's largest stock exchange, he had opposed the new securities laws when President Roosevelt originally proposed them.[25]

During the recessionary year of 1937, Whitney's firm, Richard Whitney & Co., became strapped for cash.[26] To prop up the firm, Whitney used some of his clients' securities as collateral (without authorization), including securities belonging to the New York Yacht Club, of which he was the treasurer. Although members of the NYSE Committee were aware of these unlawful activities, they took no action against Whitney.[27] A few months later, as rumors were circulating that Richard Whitney & Co. was insolvent, NYSE accountants audited the company and learned that the firm had been operating with insufficient capital. The firm quickly failed, and two customers of the firm—Mary Stevens Baird and the New York Yacht Club—sued Arthur Franklin, treasurer of the NYSE, for their losses.[28]

A majority of the Second Circuit panel, in a brief opinion by Judge Augustus Hand, affirmed the lower court's dismissal of Baird's claim on

19. *Id.* at 437.

20. *See* Carl Wartman, *Broker Dealers, Market Makers and Fiduciary Duties*, 9 LOY. U. CHI. L.J. 746, 749 (1978) (explaining that *Charles Hughes* served as the judicial affirmation of the shingle theory).

21. *Id.* at 749–50.

22. 141 F.2d 238 (2d Cir. 1944).

23. *Id.* at 239–40.

24. Michael Beschloss, *From White Knight to Thief*, N.Y. TIMES (Sept. 13, 2014), http://www.nytimes.com/2014/09/14/upshot/from-white-knight-to-thief.html?_r=0 [https://perma.cc/AR9K-TGH2].

25. *Stock Exchange Practices: Hearings on S. Res. 84 (72nd Congress) and S. Res. 56 and S. Res. 97 (73rd Congress) Before the Senate Banking and Currency Committee*, 73d Cong. 6582 *passim* (1934) (statement of Richard Whitney, President of the New York Stock Exchange).

26. *See Baird*, 141 F.2d at 240.

27. *See id.* at 241.

28. *See id.*

the grounds that she could not prove that the NYSE's inaction caused her losses.[29] Judge Clark dissented vigorously. Citing *Hughes*, Clark reasoned that, although the securities regulations do not explicitly provide for a private right of action, the purpose of the Securities and Exchange Acts is to protect unsophisticated investors from the "overreaching[]" of those who understand the securities markets.[30] Without a private right of action, Clark argued, the "avowed purpose of [protecting investors] would indeed be a snare and a delusion."[31] Although it did not carry the day in the Second Circuit, the Ninth Circuit later adopted Judge Clark's reasoning.[32] Judge Clark's dissent also provided a legal foundation to hold stock exchanges liable for the activities of their members and was one of the first opinions to articulate a theory of private action under the securities laws. Less than two months after his *Baird* dissent, Justice Clark cited his dissent in an opinion suggesting that the Securities and Exchange Acts implied a private right of action.[33]

B. Development of the Private Right of Action

In retrospect, the Second Circuit's eventual holding that the securities laws create a private right of action for fraud was one of the most significant Second Circuit rulings on securities regulation in history, although that may not have been apparent at the time, when federal courts regularly fashioned private rights of action based on traditional tort law concepts and the equity maxim that "every right withheld must have a remedy."[34] The Supreme Court championed this principle as early as *Marbury v. Madison*,[35] proclaiming, "[i]t is a settled and invariable principle, that every right, when withheld, must have a remedy, and every injury its proper redress."[36] This sentiment reached its heyday in the Supreme Court's 1917 decision in *Texas & Pacific Railway Co. v. Rigsby*,[37] a decision later used to find private rights of action under the securities laws, in which the Court found:

> A disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is

29. *Id.* at 239.

30. *Id.* at 245 (Clark, J., dissenting).

31. *Id.*

32. Fratt v. Robinson, 203 F.2d 627, 631 (9th Cir. 1953) ("We are in substantial agreement with Judge Clark's dissenting opinion in the case of Baird v. Franklin . . . .").

33. Goldstein v. Groesbeck, 142 F.2d 422, 427 (2d Cir. 1944). Judge Augustus Hand, who had written the majority opinion in *Baird*, joined that opinion.

34. Susan J. Stabile, *The Role of Congressional Intent in Determining the Existence of Implied Private Rights of Action*, 71 NOTRE DAME L. REV. 861, 864 n.15 (1996); *see, e.g.*, Tex. & Pac. Ry. Co. v. Rigsby, 241 U.S. 33, 39–40 (1916).

35. 5 U.S. 137 (1803).

36. *Id.* at 147; *see* Stabile, *supra* note 34, at 864 n.15.

37. 241 U.S. 33 (1916).

> implied . . . . This is but an application of the maxim, *Ubi jus ibi remedium* [(where there is a right, there is a remedy)].[38]

Beginning in the 1930s, the standards for recognizing new implied causes of action became stricter.[39] The explosion of governmental regulation during the New Deal led to greater reluctance by courts to imply new private rights of action. Judges were increasingly concerned that treating every violation of a federal statute or regulation as a tort that entitled private plaintiffs to sue would unleash an unmanageable flood of litigation and upset Congress's intended methods of enforcement—especially when the statutes and regulations themselves were written in broad, remedial terms that did not supply a precise rule of decision for a court to apply.[40] But the movement against implying new private rights of action was gradual—and federal courts resisted the application of this trend to the federal securities laws for several decades.[41]

At least one commentator has described the period leading up to the mid-1970s as the Supreme Court's "ebullient stage" for recognizing private rights of action under the securities laws,[42] a description that applies equally to the Second Circuit's treatment of such rights during this era.[43] Most sections of the Securities Act and the Exchange Act have no explicit provisions giving private plaintiffs the right to sue,[44] and the statutes arguably contemplated that the SEC and U.S. Department of Justice would have exclusive enforcement powers. Those agencies were explicitly empowered under the statutes to pursue administrative, civil, and criminal remedies, while the statutes were silent about private litigation.[45] During the 1950s and 1960s, federal courts nevertheless recognized private rights of action under key provisions, including section 10(b), Rule 10b-5 (the general antifraud provision), and section 14(a) (the requirement to abide by the SEC's regulations in soliciting proxies) of the Exchange Act. The Second Circuit had a leading role in creating these implied causes of action.[46]

In *Fischman v. Raytheon Manufacturing Co.*,[47] the Second Circuit became the first appellate court in the country to hold that there is an

38. *Id.* at 39–40; *see, e.g.*, H. Miles Foy, III, *Some Reflections on Legislation, Adjudication, and Implied Private Actions in the State and Federal Courts*, 71 CORNELL L. REV., 501, 554–55 (1986); Donald M. Klein, *The Extension of a Private Remedy to Defrauded Securities Investors Under SEC Rule 10b-5*, 20 U. MIAMI L. REV. 81, 88 (1965).

39. *See, e.g.*, Alexander v. Sandoval, 532 U.S. 275, 288–90 (2001); Stabile, *supra* note 34, at 865.

40. *See* Foy, *supra* note 38, at 549–50, 554–56.

41. *See* Roy L. Brooks, *Rule 10b-5 in the Balance: An Analysis of the Supreme Court's Policy Perspective*, 32 HASTINGS L.J. 403, 411 (1980).

42. 2 LOUIS LOSS ET AL., FUNDAMENTALS OF SECURITIES REGULATION 1625–28 (2011).

43. Brooks, *supra* note 41, at 411.

44. *See* LOSS ET AL., *supra* note 42, at 1615 (noting that besides the provision voiding contracts in violation of the act under section 29(b), sections 9(e), 16(b), and 18 are the only sections of the Exchange Act that have express private civil liability provisions).

45. *See* 15 U.S.C. §§ 77t, 78u (2012); LOSS ET AL., *supra* note 42, at 1928–29.

46. Brooks, *supra* note 41, at 411.

47. 188 F.2d 783 (2d Cir. 1951).

implied private right of action for fraud under Rule 10b-5.[48] Six years earlier, Judge Andrew Kirkpatrick of the Eastern District of Pennsylvania had recognized such an implied right,[49] serving as a catalyst for other courts around the country.[50] When the Second Circuit decided *Fischman*, Judge Jerome Frank took the existence of such an implied right nearly as a given, dedicating only two sentences to the issue in the body of the opinion: "Section 10(b), to be sure, does not explicitly authorize a civil remedy. Since, however, it does make 'unlawful' the conduct it describes, it creates such a remedy."[51] Judge Frank added a footnote with a lengthy quotation from a *Yale Law Journal* article that argued that Congress had intended to create a private right of action under the securities laws.[52]

Although the Second Circuit made quick work of creating a private right of action under the section 10(b) antifraud provision, it hesitated to expand the private right of action to section 14(a), which requires certain disclosures in proxy solicitations. Four years after *Fischman*, in *Subin v. Goldsmith*,[53] a fractured panel affirmed dismissal of claims brought by a shareholder under section 14(a). Judge Harold Medina, in an opinion concurring (in part) with the result, argued that "it is at least doubtful that it was the intention of the Congress to create any substantive rights by the provisions of [s]ection 14(a)."[54]

Judge Frank dissented and argued that section 14(a) was no different than other sections of the Securities Act and the Exchange Act under which the court had already recognized implied private rights of action.[55] Judge Frank's *Subin* dissent soon won out. In *Brown v. Bullock*,[56] Judge Clark predicted that the Second Circuit would have to revisit "the much criticized" decision in *Howard v. Furst*,[57] which had reiterated the *Subin* majority's position.[58] The Supreme Court did so first, abrogating *Furst* in its 1964 decision *J.I. Case Co. v. Borak*[59] and adopting Judge Frank's position.[60] That holding endures to this day.[61]

48. In dicta, *Slavin v. Germantown Fire Insurance Co.*, 174 F.2d 799 (3d Cir. 1949), suggested the existence of a private right of action under Rule 10b-5 was suggested. *See id.* However, the Second Circuit was the first appellate court to hold that a private right of action actually exists under Rule 10b-5.

49. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946); William C. Baskin III, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 YALE L.J. 1591, 1591 n.4 (1990).

50. *See* WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 590–91 & n.20 (2003).

51. *Fischman*, 188 F.2d at 787.

52. *See id.* at 787 n.4 (quoting *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1134 (1950)).

53. 224 F.2d 753 (2d Cir. 1955).

54. *Id.* at 774 (Medina, J., concurring in part, dissenting in part).

55. *Id.* at 765–66 (Frank, J., dissenting).

56. 294 F.2d 415 (2d Cir. 1961).

57. 238 F.2d 790 (2d Cir. 1956).

58. *See Bullock*, 294 F.2d at 415, 422 (Clark, J., concurring).

59. 377 U.S. 426 (1964). The Second Circuit acknowledged as much in *Studebaker Corp. v. Gittlin*, 360 F.2d 692, 695 (2d Cir. 1966).

60. *Borak*, 377 U.S. at 435.

61. *See, e.g.*, Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1104 n.11 (1991).

The Second Circuit also played a central role in shaping the territorial scope of the private rights of action during the 1960s and 1970s.[62] In *Schoenbaum v. Firstbrook*,[63] the Second Circuit found that an American investor could sue a foreign issuer under Rule 10b-5 if the conduct "has . . . a sufficiently serious effect upon [U.S.] commerce to warrant assertion of jurisdiction for the protection of American investors."[64] Four years later, in *Leasco Data Processing Equipment Corp. v. Maxwell*,[65] Judge Friendly decided that foreign plaintiffs also could seek damages under Rule 10b-5 if a substantial amount of the allegedly fraudulent conduct occurred in the United States.[66] *Schoenbaum* and *Leasco* served as the twin origins of the "conduct and effects" test to determine the extraterritorial scope of 10b-5.[67] The other circuits followed the Second Circuit's lead and adopted versions of these tests, with some circuits even debating whether each court had "accurately" captured the Second Circuit's jurisprudence.[68]

C. SEC Enforcement

Even as private remedies under the securities laws expanded, the basic authority of the SEC to bring enforcement actions was frequently challenged in the years after the securities laws were adopted.[69] Due to its location, the Second Circuit became the primary arbiter of the SEC's authority—and Second Circuit judges sympathetic to the agency's goals proved useful to the SEC.[70] The Second Circuit, tracking the political

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62. *See* LOSS ET AL., *supra* note 42, at 2026–27 & n.1.

63. 405 F.2d 200 (2d Cir. 1968), *abrogated by* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).

64. *Id.* at 209.

65. 468 F.2d 1326 (2d Cir. 1972), *abrogated by Morrison*, 561 U.S. 247.

66. *See id.* at 1337.

67. The conducts and effects test asks (1) "whether the wrongful conduct had a substantial effect in the United States or upon [U.S.] citizens" or (2) whether "substantial acts in furtherance of the fraud were committed within the United States." *See, e.g.*, SEC v. Berger, 322 F.3d 187, 192–93 (2d Cir. 2003), *abrogated by Morrison*, 561 U.S. 247.

68. *See, e.g.*, Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 665 n.10 (7th Cir. 1998), *abrogated by Morrison*, 561 U.S. 247. Of course, both *Schoenbaum* and *Leasco* were later abrogated by the Supreme Court's ruling in *Morrison v. National Australian Bank Ltd.*, 561 U.S. 247 (2010). *See infra* Part II.D.

69. *See, e.g.*, Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943) (involving one of the earliest SEC enforcement actions); *see also* R.H. Johnson & Co. v. SEC, 198 F.2d 690 (2d Cir. 1952) (involving a challenge to an SEC order that provided for the suspension of a company from membership in the National Association of Securities Dealers (NASD)); Phillips v. SEC, 153 F.2d 27 (2d Cir. 1946) (involving a challenge to an SEC order providing for a change in the capital structure of a corporation).

70. *See* John P. Frank, *The Top U.S. Commercial Court*, FORTUNE, Jan. 1951, at 92. In the 1940s and 1950s, Judges Clark and Frank provided the SEC with an expertise in securities laws that was scarcely paralleled in both the judiciary and the academy. See *supra* Part II.B for a description of the prowess of Judge Clark in *Fischman v. Raytheon Manufacturing Co.*, 188 F.2d 783 (2d Cir. 1951), and the prescience of Judge Frank's dissent in *Subin v. Goldsmith*, 224 F.2d 753 (2d Cir. 1955). It was little wonder that the Second Circuit was considered the best commercial circuit in the country at the time. *See* James Oakes, *Personal Reflections on Learned Hand and the Second Circuit*, 47 STAN. L. REV.

economy of the time, granted fairly broad authority to the SEC to protect the public against savvier investors that would prey upon them. This is not to say that the Second Circuit provided the SEC with a blank check.[71] Nonetheless, in the aggregate, the Second Circuit served as friend, rather than foe, to the SEC in its formative years.

Somewhat surprisingly, the SEC's enforcement powers were relatively limited until 1990.[72] The SEC could enjoin future violations of law and seek the equitable assistance of federal courts to obtain disgorgement or restitution for violations.[73] But the SEC had no power to seek financial penalties in most cases.[74] When several major financial scandals came to light in the 1980s,[75] Congress created the National Commission on Fraudulent Financial Reporting ("the Commission") to suggest ways in which fraud could be reduced.[76] The Commission, headed by former SEC Commissioner James Treadway, Jr., recommended expanding the enforcement remedies allotted to the SEC.[77] In response, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act ("the Remedies Act") in 1990, which expanded the SEC's power to include four new classes of penalties, ranging from civil monetary penalties to officer and director bars.[78]

387, 387–88 (1994) (collecting praise of the Second Circuit during Learned Hand's tenure on the court).

71. Judge Friendly's opinion in *Arthur Lipper Corp. v. SEC*, 547 F.2d 171 (2d Cir. 1976), is demonstrative of the pragmatic manner in which the Second Circuit dealt with the SEC. *Lipper* concerned the appeal of a broker, Lipper Corp., from an order by the SEC cancelling its registration and barring it from participating in the securities market. *Id.* at 173. Judge Friendly read narrowly an earlier Second Circuit case, *Wright v. SEC*, 112 F.2d 89 (2d Cir. 1940), that had suggested that the Second Circuit lacked power to review penalties imposed by the SEC. He ruled that debarment was "too severe" a sanction and modified the sanction to a twelve-month suspension of Lipper's registration. *Id.*; *see also* Touche Ross & Co. v. SEC, 609 F.2d 570, 583 (2d Cir. 1979) (Kaufman, J., concurring) (noting that while the SEC's "findings and choice of sanctions will often be upheld on review," the "courts have not remained idle" when the SEC goes too far in pursuing its objectives); Klein v. SEC, 224 F.2d 861, 866 (2d Cir. 1955) (holding that an SEC disciplinary action against a broker for the violation of the NASD Rules of Fair Practice was unsubstantiated and therefore constituted error).

72. *See* Richard A. Spehr & Michelle J. Annunziata, *The Remedies Act Turns Fifteen: What Is Its Relevance Today?*, 1 N.Y.U. J.L. & BUS. 587, 588 (2005) (noting the SEC's limited power to impose penalties prior to the passing of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990).

73. Insider trading was one exception. *Id.*; *see also* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 390 (2d Cir. 1973) (noting that the SEC has no statutory authority to seek rescission, restitution, or other forms of equitable monetary relief but may seek the equitable assistance of a district court).

74. Spehr & Annunziata, *supra* note 72.

75. *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 387 (2008) (noting how "[i]n the mid-1980s, insider-trading scandals dominated the financial news").

76. *Id.* at 388.

77. *Id.* at 388–89.

78. *See* Spehr & Annunziata, *supra* note 72, at 589 (noting that the four new classes of SEC authority included "(1) cease and desist authority; (2) civil monetary penalties; (3) disgorgement of ill-gotten gains; and (4) officer and director bars").

The Second Circuit suddenly had to adjudicate the legitimacy of the SEC's power in an age where it had a significantly expanded arsenal of sanctions at its disposal.[79] *SEC v. Patel*[80] is an important example of the court's approach to the most drastic sanction provided by the Remedies Act: the power to prohibit an individual from serving as an officer or director of any public company where that person's conduct "demonstrates *unfitness* to serve as an officer or director."[81] In *Patel*, appellant-defendant Ratilal Patel, founder and director of Par Pharmaceutical, Inc., had submitted a misleading application to the Food and Drug Administration (FDA) for approval of a new generic medication.[82] A few months before the news of this misleading application came to light, Patel sold a significant amount of his common stock in Par.[83] Once it became public knowledge that Patel's application was misleading, Par's stock price declined appreciably.[84] Patel ultimately resigned and pled guilty to conspiring to defraud the FDA.[85] The SEC then proceeded with its own enforcement order in the Southern District of New York, and the district court, at the SEC's urging, imposed various civil penalties upon Patel, including an order barring him from serving as an officer or director of a public company.[86]

Patel appealed, and the Second Circuit reversed the sanctions imposed against him.[87] Relying on the heightened standard of "substantial unfitness" provided in the Remedies Act, the court held that, despite the gravity of Patel's misdeeds, "[t]he loss of livelihood and the stigma attached to permanent exclusion from the corporate suite . . . requires more."[88] In particular, the court noted that it was essential, in the absence of past violations, "that a district court articulate the factual basis for a finding of the likelihood of recurrence" necessary to justify the imposition of a permanent bar.[89]

Patel was quickly seen as a significant decision. Other circuits adopted the Second Circuit's *Patel* standard.[90] Stephen M. Cutler, director of the SEC's Enforcement Division at the time, criticized the *Patel* decision for creating "a burdensome and overly restrictive test" that placed "an unreasonably high" burden on the SEC.[91] In response to *Patel* and other

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79. *Id.*
80. 61 F.3d 137 (2d Cir. 1995).
81. 15 U.S.C. §§ 77t(e), 78u(d)(2) (2012) (emphasis added).
82. *Patel*, 61 F.3d at 138.
83. *Id.*
84. *Id.*
85. *Id.* at 139.
86. *Id.*
87. *Id.* at 142.
88. *Id.*
89. *Id.*
90. *See, e.g.*, SEC v. First Pac. Bancorp., 142 F.3d 1186, 1193 (9th Cir. 1998).
91. Stephen M. Cutler, Dir., Div. of Enf't, U.S. SEC, Remarks at the Glasser Legal Works 20th Annual Federal Securities Institute (Feb. 15, 2002), https://www.sec.gov/news/speech/spch538.htm [https://perma.cc/2FX9-8Z52].

decisions applying its principle,[92] the SEC reduced the number of cases in which it sought officer bars in order to avoid rejection from the courts.[93]

The Second Circuit's interpretation of "substantial fitness" remained good law through the early 2000s, when the Internet bubble popped and Enron collapsed. Soon thereafter, Congress passed the Sarbanes-Oxley Act in 2002.[94] Sarbanes-Oxley, like the Remedies Act, responded to various financial indiscretions by increasing the sanctioning power of the SEC. Notably, Sarbanes-Oxley responded to the SEC's concerns regarding *Patel* by lowering the standard for entering a suspension or bar order from a "*substantial* unfitness to serve as an officer or director" to merely "unfitness" to perform such roles.[95] In other words, the Second Circuit's *Patel* decision helped spur Congress to give the SEC more power to deal effectively with financial indiscretion. Congress further expanded the SEC's power in enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act[96] in 2010, arguably the most impactful piece of regulatory legislation since the Glass-Steagall Act of 1933.

In contrast to its holding narrowing the punitive purview of the SEC in *Patel*, the Second Circuit upheld and even expanded the power of district courts to fashion other equitable remedies. In *SEC v. First Jersey Security, Inc.*,[97] the court made clear that district courts have broad discretion in fashioning equitable remedies for securities violations.[98] *First Jersey* concerned a company that had induced its customers to buy various securities from the firm at excessive prices through fraudulent practices.[99] The SEC initiated an enforcement action against the company, and a bench trial followed in the Southern District of New York.[100] The district court held the defendants liable for federal securities law violations and enjoined future violations, ordered disgorgement of unlawful gains, and assessed prejudgment interest.[101] On appeal, the Second Circuit upheld nearly all of the district court's sanctions, noting that once a "district court has found federal securities law violations, it has broad equitable power to fashion

92. *See, e.g.*, SEC v. McCaskey, No. 98-cv-6153 (SWK), 2001 WL 1029053, at *6 (S.D.N.Y. Sept. 6, 2001) (citing to *Patel* in denying the SEC's request for a permanent officer and director bar against a recidivist defendant who manipulated his company's stock price); SEC v. Farrell, No. 95-CV-6133T, 1996 WL 788367, at *8 (W.D.N.Y. Nov. 6, 1996) (applying *Patel* in denying a permanent bar for a defendant convicted and jailed for insider trading).

93. *See* Cutler, *supra* note 91 (noting that "the [SEC] is compelled to seek in court only what it realistically can expect to obtain").

94. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1544–45 (2005) (describing the background behind the act's passing).

95. 15 U.S.C. §§ 77t(e), 78u(d)(2) (2012).

96. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

97. 101 F.3d 1450 (2d Cir. 1996).

98. *Id.* at 1474–75.

99. *Id.* at 1456.

100. *Id.* at 1459.

101. *Id.* at 1459–62.

appropriate remedies."[102] The Second Circuit's ruling in *First Jersey* demonstrates that, while it was loath to allow the imposition of a penalty as severe as the permanent bar without significant justification, it did allow courts relative freedom otherwise in fashioning equitable relief.

The Second Circuit's role in close oversight of the SEC's enforcement power continues to this day. Like many civil and criminal actions filed in the federal courts, many SEC investigations never reach the point of enforcement but rather settle before they even reach the courts.[103] An important tool in the SEC's arsenal has been the "no admit, no deny" consent agreement—in which the defendant agrees to certain penalties without admitting or denying wrongdoing.[104] For many years, courts often approved consent agreements after a cursory review and without probing the appropriateness of such a settlement.[105]

The supremacy of the "no admit, no deny" model has been shaken recently, both by the SEC and in some courts. In 2013, the SEC changed its policy on these settlements by expanding the categories and circumstances in which the SEC would demand admissions from defendants.[106] And in *SEC v. Citigroup Global Markets Inc.*,[107] Judge Jed Rakoff of the Southern District of New York refused to approve a "no admit, no deny" proposed consent agreement between the SEC and Citigroup on the grounds that the agreement was "neither fair, nor reasonable, nor adequate, nor in the public interest" because Citigroup did not have to accept responsibility for the loss it caused investors.[108]

The Second Circuit reversed Judge Rakoff's decision.[109] The court held that Judge Rakoff had abused his discretion in requiring that the SEC "establish the 'truth' of the allegations against a settling party as a condition for approving the consent decrees."[110] Moreover, the court determined that the business of determining the public interest "rests squarely with the SEC," not the courts.[111] Thus, *Citigroup* reiterated that the SEC could still count on deference from the Second Circuit when it came to negotiating consent agreements. Just as the Second Circuit had granted the SEC significant deference in the aftermath of the Great Depression, *Citigroup*

102. *Id.* at 1474. The court denied only the district court's appointment of a special agent to investigate whether First Jersey had committed other frauds. *Id.* at 1479.

103. *See* George L. Miles, Note, *Let Judges Judge: Advancing a Review Framework for Government Securities Settlements Where Defendants Neither Admit nor Deny Allegations*, 46 CONN. L. REV. 1111, 1114 (2014) ("[T]he SEC settles its investigations anywhere from 67%, to 90%, or 98% of the time.").

104. Matthew G. Neumann, Note, *Neither Admit nor Deny: Recent Changes to the Securities and Exchange Commission's Longstanding Settlement Policy*, 40 J. CORP. L. 793, 796 (2015).

105. *Id.* at 798–99.

106. *Id.* at 794.

107. 827 F. Supp. 2d 328 (S.D.N.Y. 2011).

108. *Id.* at 332.

109. *See* SEC v. Citigroup Global Mkts., Inc., 752 F.3d 285 (2d Cir. 2014).

110. *Id.* at 295.

111. *Id.* at 296.

demonstrates that the court continues to afford such deference well after the Great Recession.[112]

D. Reining In Private Securities Fraud Cases

The Second Circuit's jurisprudence creating private rights of actions under the securities laws eventually led to a sharp rise in the number of Rule 10b-5 fraud lawsuits.[113] The proliferation of securities fraud suits raised concerns that the securities laws were inviting frivolous lawsuits (colloquially termed "strike suits")[114] and that plaintiffs' allegations often amounted to "fraud by hindsight."[115] Corporations would settle even frivolous cases because of the huge costs required to litigate such suits.[116]

These factors led the Supreme Court and the Second Circuit to rein in private lawsuits starting in 1975. That year, in *Blue Chip Stamps v. Manor Drug Stores*,[117] the Supreme Court adopted the Second Circuit's holding from *Birnbaum v. Newport Steel Corp.*[118] that only actual purchasers and sellers of a security could sue under Rule 10b-5.[119] The Second Circuit's impact could be felt throughout the Supreme Court's opinion. In the majority opinion, Justice William Rehnquist noted that the Second Circuit's *Birnbaum* panel consisted of Chief Judge Thomas Swan and Judges Learned Hand and Augustus Hand, and that "virtually all" lower courts had adopted the rule.[120] Even in dissent, Justice Harry Blackmun acknowledged that the *Birnbaum* decision "was pronounced by a justifiably esteemed panel of that Court of Appeals regarded as the 'Mother Court' in this area of the law."[121]

In two other decisions of the same period, the Supreme Court curtailed some of the Second Circuit's securities jurisprudence as part of its broader efforts to narrow the scope of the private right of action. In *Ernst & Ernst v. Hochfelder*,[122] the Supreme Court held that private plaintiffs must show scienter, not merely negligence, for Rule 10b-5 civil liability—a shift

112. Private institutions did not receive such deference from the Second Circuit. A few years before it demonstrated its deference to the SEC's remedies in *Citigroup*, the Second Circuit denied the Financial Industry Regulatory Authority (FINRA)—a private self-regulating national securities organization—the same deference. In *Fiero v. Financial Industry Regulatory Authority, Inc.*, 660 F.3d 569 (2d Cir. 2011), the Second Circuit faced a case in which FINRA sought to enforce monetary penalties against several of its members. The Second Circuit ultimately held that FINRA lacked the necessary authority to enforce its pecuniary penalties in federal court. *Id.* at 574.

113. ALLEN & KRAAKMAN, *supra* note 50, at 598 (concerning the emergence of private rights of action within the sphere of derivative suits).

114. Brooks, *supra* note 41, at 426 n.138 (discussing the use of statute to deter frivolous derivative claims).

115. *See* Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000).

116. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975); William C. Baskin III, *supra* note 49, at 1597–98 & n.43.

117. 421 U.S. 723 (1975).

118. 193 F.2d 461 (2d Cir. 1952).

119. *See id.* at 464.

120. *Blue Chip Stamps*, 421 U.S. at 731.

121. *Id.* at 762 (Blackmun, J., dissenting).

122. 425 U.S. 185 (1976).

toward the views expressed in Judge Friendly's well-known *SEC v. Texas Gulf Sulphur Co.*[123] concurrence.[124] Likewise, in another reversal of a Second Circuit decision, the Supreme Court found in *Santa Fe Industries v. Green*[125] that "corporate mismanagement" alone is not actionable under Rule 10b-5.[126]

Beginning in the late 1970s, the Second Circuit, sharing the Supreme Court's increasing concerns about frivolous private security actions, began to narrow the private right of action under Rule 10b-5 by requiring plaintiffs in the early stages of litigation to plead their claims with heightened particularity to avoid dismissal.[127] Understanding this shift requires some historical explanation. In the early nineteenth century, courts demanded that plaintiffs plead their claims in a new lawsuit using precise, highly stylized language.[128] Dissatisfied with this emphasis on technicalities, legislatures began enacting statutory rules of procedure that banned excessive formalism. For example, New York's Field Code, adopted in 1848, merely required pleadings at the outset of the lawsuit to include "[a] statement of the facts constituting the cause of action, in ordinary and concise language, without repetition, and in such a manner as to enable a person of common understanding to know what is intended."[129]

Despite these new statutory rules, courts continued to emphasize formality, and pleading continued to serve as a confusing trap for the unwary.[130] To break from this extreme formalism, Judge Charles Clark, then dean of Yale Law School, and the other drafters of the Federal Rules of Civil Procedure (FRCP) ultimately decided to require plaintiffs to file nothing more than "a short and plain statement of the claim showing that the pleader is entitled to relief."[131] But, in a compromise, the drafters required more of plaintiffs seeking to bring fraud claims, because of the frequency of strike suits alleging fraud. Under Rule 9(b) of the FRCP, a plaintiff bringing a fraud claim must "state with particularity the circumstances constituting fraud or mistake."[132]

When applying these rules, courts have long debated the proper balance between allowing vague claims to proceed to burdensome discovery and the risk that meritorious lawsuits will be dismissed.[133] Judge Jerome Frank championed very lenient pleading requirements. In his *Subin* dissent, Frank warned against "revert[ing] to the days when courts construed pleadings

123. 401 F.2d 833 (2d Cir. 1968).
124. *See Ernst & Ernst*, 425 U.S. at 209–14, 217 (Blackmun, J., dissenting).
125. 430 U.S. 462 (1977).
126. *Id.* at 479.
127. *See* Richard L. Marcus, *The Revival of Fact Pleading Under the Federal Rules of Civil Procedure*, 86 COLUM. L. REV. 433, 435 (1986).
128. *Id.*
129. *Id.* at 438.
130. *Id.*
131. *Id.* at 433; *see also* FED. R. CIV. P. 8(a)(2).
132. FED. R. CIV. P. 9(b).
133. MICHAEL A. PERINO, SECURITIES LITIGATION UNDER THE PSLRA, at vii (2015).

with what today courts consider unreasonable strictness."[134] He rejected the notion that shareholder lawsuits should be treated any differently:

> An economy like ours, which thrives on the fact that thousands of persons of modest means invest in corporate shares, will be poorly served if our courts regard with suspicion all minority stockholders' suits, and therefore, out of a desire to discourage such suits, apply to them unusually strict pleading rules . . . . The unfortunate consequence will be that those in control may be immunized from effective attacks on their misdeeds, and, as a result, the small investors will lose confidence in all corporate managements, the honest as well as the dishonest.[135]

The standard, Judge Frank argued, should only be whether "the plaintiff would be entitled to no relief under any set of facts which could be proved."[136] For Judge Frank, the heightened pleadings standard under Rule 9(b) played no role in securities lawsuits and, even if it did, its effect was limited.[137]

With the flood of Rule 10b-5 lawsuits, the Second Circuit turned sharply away from the "no set of facts" standard of review. In *Ross v. A.H. Robins Co.*,[138] the Second Circuit substituted in a new pleading standard for securities suits, holding that under Rule 9(b) a plaintiff must "specifically plead those events which they assert give rise to a strong inference [of scienter]."[139] Drawing upon the Supreme Court's language in *Blue Chip Stamps*, the Second Circuit found that the heightened pleading standard

> diminish[es] the possibility that "a plaintiff with a largely groundless claim [will be able] to simply take up the time of a number of other people [by extensive discovery] with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonable founded hope that the process will reveal relevant evidence."[140]

This so-called "strong inference of scienter standard" eventually developed into a two-part test, which required a plaintiff (1) to "alleg[e] facts to show that defendants had both motive and opportunity to commit fraud" or (2) to "alleg[e] facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."[141]

While two other circuits adopted the Second Circuit's "strong inference" standard, other courts declined to do so.[142] Those courts maintained that the Second Circuit's strong inference test contradicted Rule 9(b)'s plain

134. Subin v. Goldsmith, 224 F.2d 753, 764 (2d Cir. 1955) (Frank, J., dissenting).
135. *Id.* at 767.
136. *Id.* at 764.
137. *Id.* at 766.
138. 607 F.2d 545 (2d Cir. 1979).
139. *Id.* at 558.
140. *Id.* at 557 (quoting Denny v. Barber 576 F.2d 465, 470 (2d Cir. 1978)).
141. Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994); PERINO, *supra* note 133, at 3–11.
142. *See, e.g.*, *In re* GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1543 (9th Cir. 1994) (en banc), *superseded by statute as recognized in* Ronconi v. Larkin, 253 F.3d 423, 437 n.6 (9th Cir. 2001); Phelps v. Wichita Eagle-Beacon, 886 F.2d 1262, 1270 n.5 (10th Cir. 1989); PERINO, *supra* note 133, at 3–15.

language that "intent . . . may be alleged generally."[143] Another group of courts purported to adopt the Second Circuit's strong inference standard, but in practice applied the standard with less rigor.[144]

But the Second Circuit's approach ultimately won out when Congress intervened in 1995 with the Private Securities Litigation Reform Act (PSLRA). To curb abusive securities lawsuits and to achieve uniformity among the circuits, the PSLRA adopted the Second Circuit's strong inference of scienter standard as a statutory pleading requirement in all securities fraud cases. Hence, all plaintiffs bringing securities fraud claims now must plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[145]

Since the enactment of the PSLRA, much debate has centered over how to treat the Second Circuit's earlier jurisprudence—especially the Second Circuit's still uncodified two-part test—in giving meaning to the PSLRA's strong inference standard. In *Novak v. Kasaks*,[146] the Second Circuit found that the PSLRA did not substantially change the Second Circuit's pleading standard.[147] While *Novak* disclaimed any rigid reliance on "magic words such as 'motive and opportunity,'" the court concluded that its prior jurisprudence could prove "helpful" in determining what allegations meet the strong inference of scienter standard.[148] Thus, with the adoption of the PSLRA, the Second Circuit's influence in this area lives on.

Another example of the Second Circuit limiting the scope of the private right of action concerns the extraterritorial application of securities laws. In 2010, forty-two years after *Schoenbaum*, the Supreme Court, in *Morrison v. National Australia Bank*,[149] put an end to the Second Circuit's "conduct and effects" test by limiting the circumstances in which foreign investors could make use of the securities laws to sue over foreign-based conduct.[150] Yet even there, the Second Circuit and Judge Friendly took center stage. In his concurrence, Justice Stevens called the Second Circuit's conduct and effects test the "north star" coming from the "'Mother Court' of securities law" which has "tended to [the] oak" that grew from the "acorn" of Rule 10b-5.[151] Justice Stevens heaped his greatest praise on Judge Friendly, the author of *Leasco*, who he termed "the master arborist."[152]

143. FED. R. CIV. P. 9(b); *see, e.g.*, *GlenFed*, 42 F.3d at 1546–47; *Phelps*, 886 F.2d at 1270 n.5; PERINO, *supra* note 133, at 3–15.

144. PERINO, *supra* note 133, at 3–15.

145. 15 U.S.C. § 78u-4(b)(2)(A) (2012); *see* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 321 (2007).

146. 216 F.3d 300 (2d Cir. 2000).

147. *Id.* at 305–06.

148. *Id.* at 311.

149. 561 U.S. 247 (2010).

150. *Id.* at 273.

151. *Id.* at 275–76 (Stevens, J., concurring) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (Blackmun, J., dissenting)).

152. *Id.* Not to be outdone, Justice Scalia responded that "[e]ven if one thinks that the 'conduct' and 'effects' test are numbered among Judge Friendly's many fine contributions to the law, his successors, though perhaps under the impression that they nurture the same mighty oak, are in reality tending each its own botanically distinct tree." *Id.* at 259 n.4.

Since *Morrison*, the Second Circuit has begun to develop a new body of law delimiting the territorial scope of the securities laws. In *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings*,[153] the Second Circuit concluded that a transaction in the United States was necessary, but not sufficient, for a private plaintiff to seek redress under Rule 10b-5 for securities not registered on a U.S. exchange.[154] The decision addressed securities-based swap agreements—transactions designed to simulate the purchase and short sale of a stock between two counterparties, without either party needing to own the actual security. The parties to the swap simply select a reference price and agree to exchange money (as opposed to the stock itself) based on the stock's subsequent performance.[155] The swaps in *Parkcentral Global Hub* were executed in the United States, but the allegedly tortious conduct affecting the stock's price occurred abroad, and the security was not traded on a U.S. exchange.[156] The Second Circuit concluded that, although the swap parties effectuated the transactions in the United States, "the dominance of the foreign elements" foreclosed Rule 10b-5 private liability.[157] In finding for the defendants, the Second Circuit declined to establish a bright-line test for determining whether a transaction is sufficiently domestic, but left the issue open for future development.[158]

II. CRIMINAL ENFORCEMENT OF THE SECURITIES LAWS

The Second Circuit's preeminence in securities regulation is also reflected in its criminal jurisprudence in this area. Second Circuit decisions sustaining criminal convictions for financial crimes have played a key role in making criminal prosecution for corporate malfeasance a real weapon.

A. Scienter and Criminal Intent

One important question that the Second Circuit addressed in a series of cases is the meaning of "scienter" in criminal cases. "Scienter" is a legal term that refers to an actor's "intent" or "knowledge." To convict a defendant of a financial crime, the government generally must prove that the defendant acted with scienter, for example, wrongful intent. Difficult questions sometimes arise as to whether and to what extent it is desirable to impose criminal liability in situations where the violation was inadvertent and the offender has no readily ascertainable motive.

In 1969, Judge Henry Friendly's opinion in *United States v. Simon*[159] became one of the first cases to attempt to define what constitutes a "willful" and "knowing" misstatement of fact sufficient for criminal liability under the Exchange Act. The defendants in *Simon* were three

153. 763 F.3d 198 (2d Cir. 2014).
154. *Id.* at 215.
155. *Id.* at 205–07.
156. *See id.* at 212–14.
157. *Id.* at 212–17.
158. *Id.* at 217–18.
159. 425 F.2d 796 (2d Cir. 1969).

accountants at Lybrand, Ross Bros. & Montgomery, a leading public accounting firm, who had been convicted of securities fraud for creating, certifying, and subsequently mailing false and misleading financial statements for a client of theirs.[160] The defendants argued that they had complied with the literal terms of the General Accepted Accounting Principles (GAAP) and that compliance alone was sufficient to preclude any finding that they had intentionally violated the securities laws.[161] The court rejected this argument, and found that even an accountant who complies with GAAP can be liable if the financial statements create a false or misleading impression.[162]

In the wake of *Simon*, a number of other circuits concluded that following GAAP was not sufficient to shield an accountant from liability.[163] In a 2002 statement discussing the massive Enron accounting fraud, then-SEC Chairman Harvey Pitt explained that

> the first principle should always be the one Judge Henry Friendly articulated four decades ago in the Lybrand Ross criminal case, [*United States*] *v. Simon*. . . . [I]f literal compliance with GAAP creates a fraudulent or materially misleading impression in the minds of shareholders, the accountants could, and would, be held criminally liable.[164]

Simon ultimately resulted in efforts to develop more detailed accounting guidelines.[165]

Judge Friendly authored opinions in two additional widely cited cases that established that it is no defense that the defendant did not know the precise contours of the regulation that he violated.[166] In *United States v. Peltz*,[167] the defendant learned from a connection of his at the SEC that the Commission intended to file charges against Georgia Pacific Corporation.[168] He then shorted Georgia Pacific's stock[169] and caused his broker to violate Rule 10a-1(a) ("the down-tick rule")—which prohibits a short sale at a price lower than the last reported price—by falsely telling his

160. *Id.* at 798–801.

161. *See* Elliott J. Weiss, *The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?*, 38 ARIZ. L. REV. 675, 702 n.164 (1995) (noting that "the opinion is rooted in a view of human behavior that the years have not changed" and collecting recent cases).

162. *Simon*, 425 F.2d at 805–06.

163. *See, e.g.*, *In re* K-tel Int'l, Inc. Sec. Litig., 300 F.3d 881 (8th Cir. 2002); United States v. Weiner, 578 F.2d 757 (9th Cir. 1978).

164. Harvey L. Pitt, Chairman, U.S. SEC, Public Statement by SEC Chairman: Remarks at the Winter Bench and Bar Conference of the Federal Bar Council (Feb. 19, 2002), https://www.sec.gov/news/speech/spch539.htm [https://perma.cc/MX4J-HNSN].

165. Charles D. Niemeier, Bd. Member, Pub. Co. Acct. Oversight Bd. (PCAOB), Keynote Address on Recent International Initiatives, 2008 Sarbanes-Oxley, SEC and PCAOB Conference, New York State Society of CPAs/FAE Conference (Sept. 10, 2008), https://pcaobus.org//News//Speech//Pages//09102008_NiemeierNYSSCPAFAEConference.aspx// [https://perma.cc/ZD4N-TYWU].

166. *See* United States v. Dixon, 536 F.2d 1388 (2d Cir. 1976); United States v. Peltz, 433 F.2d 48 (2d Cir. 1970).

167. 433 F.2d 48 (1970).

168. *Id.* at 49–50.

169. *Id.* at 50.

broker that he was selling to unwind a long position he owned in the stock, rather than to establish a new short position.[170] Peltz claimed that he had no knowledge of the down-tick rule, and further, that he did not explicitly instruct the broker to make a short sale.[171] But, in affirming his conviction, the Second Circuit explained that the language of section 32(a) of the Exchange Act makes clear that "[a] person can willfully violate an SEC rule even if he does not know of its existence."[172] The court reasoned that Peltz "willfully" violated the down-tick rule, because his wrongful act of telling the broker that he was long particular stocks, when he knew that was untrue, created a "serious risk" that the rule would be violated: the broker had no way of knowing that the down-tick rule applied to the sales Peltz was making.[173]

In *United States v. Dixon*,[174] the Second Circuit further clarified the state of mind necessary for criminal liability.[175] Lloyd Dixon, Jr., the president of AVM Corporation, the largest producer of mechanical voting machines in the United States, was charged with failing to disclose personal loans he had received from the corporation, in violation of SEC rules that require such disclosures in proxy solicitations.[176] On appeal to the Second Circuit, Dixon argued that he did not know he was required to disclose the loans under the SEC rules and thus did not "willfully" violate the rules.[177] In affirming Dixon's conviction, Judge Friendly's opinion for the court emphasized that Dixon had engaged in a wrongful act when he manipulated the corporate books to make his own debts look as though they had belonged to someone else, and he reasoned that this kind of wrongful act fell squarely within the ambit of section 32(a) because it led "to the very violations that would have been prevented if the defendant had acted with the aim of scrupulously obeying the rules . . . rather than of avoiding them."[178]

The scienter standard the Second Circuit developed in these cases was widely adopted.[179] For example, in *United States v. O'Hagan*,[180] the

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170. *Id.* at 54.
171. *Id.*
172. *Id.*
173. *Id.* at 55.
174. 536 F.2d 1388 (2d Cir. 1976).
175. *Id.* at 1395, 1402.
176. *Id.* at 1391–92.
177. *Id.* at 1395–97.
178. *Id.* at 1395–96.
179. A number of other courts have embraced the Second Circuit's standard for "willfully and knowingly." *See, e.g.*, United States v. Charnay, 537 F.2d 341, 352 (9th Cir. 1976) (explicitly embracing the standard articulated in *Peltz*); *see also* United States v. Behrens, 713 F.3d 926, 929 (8th Cir. 2013) (same); Wonsover v. SEC, 205 F.3d 408, 414–15 (D.C. Cir. 2000) (rejecting the argument that specific intent to violate the law is an essential element of the willfulness required to violate and noting that such an argument had been rejected by the Second Circuit); Leng-Chia Hung, *Securities Markets—A Place to Get Rich Quick or a Quicksand Going Straight to Jail?: The "Mens Rea" Required for Insider Trading Criminal Liability*, 5 NAT'L TAIWAN U. L. REV. 1, 14 (2010) ("Following [the decision in *Peltz*], this approach for 'no requirement of defendant's knowledge of the rule' was adopted by many different jurisdictions in insider trading cases.").

Eighth Circuit relied heavily on *Dixon*'s interpretation of "willfully" to conclude that a defendant could be criminally liable for insider trading based only on "the intentional doing of the wrongful acts—no knowledge of the rule or regulation is required."[181] In fact, O'Hagan argued that he could not have known his conduct was unlawful because it implicated the "misappropriation theory" of insider trading, which was first recognized by the Supreme Court in that very case.[182] Despite this, the Eighth Circuit relied on *Dixon* and held that criminal liability did not require proof that the person knew of the rule that made his act illegal.[183]

B. Procedural Protections in Civil Enforcement Cases Preceding Criminal Charges

One complication of criminal securities fraud cases is that they often coincide with simultaneous civil proceedings. This has sometimes raised questions about how to protect the right of the accused to remain silent in the criminal proceedings while civil proceedings are also pending (in which the accused does not have the same right against self-incrimination).

This question is particularly complex because civil proceedings of an enforcement nature sometimes involve nongovernmental entities. Oversight of the securities market in the United States has always relied heavily on self-regulation by private actors. The NYSE was officially formed in 1817 and, from its inception, was permitted to "regulate its members as it saw fit."[184] In 1983, Congress amended the Exchange Act to require almost every SEC-registered brokerage firm to become a member of a national securities association or a registered exchange.[185] Because Self-Regulatory Organizations (SROs), such as the NYSE and the Financial Industry Regulatory Authority (FINRA) have their own procedures for investigating and disciplining members for violations, a number of complicated questions have arisen in SRO proceedings. The Second Circuit has led the way in considering the appropriate role of self-regulation in securities law.

United States v. Solomon[186] is considered to be "[t]he cornerstone federal decision that analyzes a claim of a privilege against self-incrimination in the context of a Self-Regulatory [O]rganization's investigation."[187] In his opinion for the court, Judge Friendly explained that where the NYSE acts or investigates "in pursuance of its own interests and obligations, not as an

180. 139 F.3d 641 (8th Cir. 1998).

181. *Id.* at 647.

182. *Id.* at 656.

183. *Id.* at 647–48.

184. Steven Irwin et al., *Self-Regulation of the American Retail Securities Markets—An Oxymoron for What Is Best for Investors?*, 14 U. PA. J. BUS. L. 1055, 1059 (2012). The NYSE's regulatory arm merged in 2007 with the NASD to become FINRA. *See id.*

185. Alan Lawhead, *Useful Limits to the Fifth Amendment: Examining the Benefits That Flow from a Private Regulator's Ability to Demand Answers to Its Questions During an Investigation*, 2009 COLUM. BUS. L. REV. 210, 217.

186. 509 F.2d 863 (2d Cir. 1975).

187. Lawhead, *supra* note 185, at 224.

agent of the [government]," it is not a "state actor" under the Fifth Amendment.[188] Accordingly, an individual is not entitled to the privilege against self-incrimination in an NYSE interrogation—even if his testimony is later used against him in a criminal prosecution. A number of other circuits have relied on the Second Circuit's reasoning in *Solomon* to conclude that other SROs were not state actors. For example, in *United States v. Stevens*,[189] the Ninth Circuit relied on Judge Friendly's opinion to conclude that the privilege against self-incrimination did not apply to investigators working for an FDIC-insured bank.[190] The Seventh Circuit in *Bernstein v. Lind-Waldock & Co.*[191] similarly relied on Judge Friendly's reasoning in *Solomon* to conclude that the privilege against self-incrimination did not apply to the Chicago Mercantile Exchange.[192]

Where an individual has violated a rule promulgated by the SRO of which he is a member, what effect should such a violation have on his potential criminal liability under the securities laws? In *United States v. Finnerty*,[193] the Second Circuit explained that a violation of a NYSE rule was not tantamount to a violation of the securities laws. The defendant in *Finnerty* was a "specialist" member of the NYSE, meaning that he was the designated auctioneer for a specific security. Finnerty engaged in the practice of "interpositioning," in violation of NYSE rules.[194] The Second Circuit reasoned that the NYSE rules did not represent a reasonable assurance by Finnerty, to his customers, that he would not engage in interpositioning—and thus he had not committed a "deceptive act" within the meaning of section 10(b) merely by violating the rules against interpositioning.[195]

Finnerty had important implications for the entire specialist system.[196] In the early 2000s, the SEC brought a number of actions against each of the NYSE specialist firms for violations of SEC Rules 11b-1 and 10b-5, resulting in administrative settlements of more than $247 million.[197] But

188. *Solomon*, 509 F.2d at 869.

189. 601 F.2d 1075 (9th Cir. 1979).

190. *Id.* at 1078.

191. 738 F.2d 179 (7th Cir. 1984).

192. *Id.* at 186.

193. 533 F.3d 143 (2d Cir. 2008).

194. Under NYSE Rule 104, traders generally were not allowed to engage in proprietary trades. When there were two matching orders from different members to the public seeking to buy and sell a security, Finnerty was required, under the rules, to match the public orders. Instead of doing so, he interposed himself between the orders—selling shares from his own account to the member of the public who was seeking to buy, and simultaneously buying shares at a lower price for his own account from the member of the public who was seeking to sell. As a result, instead of giving the members of the public a better price, he collected a "spread" for himself, reflecting the difference in the price he paid and received on the two orders from members of the public. *Id.* at 145.

195. *See* 15 U.S.C. § 78j(b) (2012).

196. One commenter noted that "by declining to apply Rule 10b-5 to a case of sizeable Specialist profits, the *Finnerty* decision . . . dampened the death knell for the Specialist system." J. Scott Colesanti, *Not Dead Yet: How New York's* Finnerty *Decision Salvaged the Stock Exchange Specialist*, 23 ST. JOHN'S J. LEGAL COMM. 1, 30 (2008).

197. *See id.* at 14.

shortly after the Second Circuit's decision in *Finnerty*, the U.S. Attorney for the Southern District of New York dropped all charges in five specialist cases that were still pending, explaining that "continued prosecution in these cases are not in the interests of justice."[198] The Second Circuit's jurisprudence had won out again.

C. Development of the "Misappropriation Theory" of Insider Trading

Neither the Securities Act nor the Exchange Act explicitly prohibits individuals from trading on the basis of nonpublic information that would be material to the reasonable investor. Indeed, trading on inside information was not even prohibited in most jurisdictions at the time the acts were passed.[199] But from the early days of the securities laws, the SEC and the courts have recognized that "insider trading" is a kind of securities fraud. The SEC's decision in *Cady, Roberts & Co.*[200] was the first to recognize liability for insider trading, reasoning that "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing" was a sufficient basis to hold the violator liable.[201]

Many of the major legal theories which serve as the foundation of insider trading law nationwide have roots in Second Circuit jurisprudence. The Second Circuit was the first court to adopt the "classical theory" of insider trading in *SEC v. Texas Gulf Sulphur Co.*[202] The defendants in this case were corporate insiders who had nonpublic information that Texas Gulf Sulphur Co., a mining company, had discovered an unusually large deposit of copper. Based on this information, the defendants bought securities in the company. The company's stock price rose soon after the news was released, netting the defendants a substantial profit. At the SEC's urging, the Second Circuit adopted the reasoning of *Cady, Roberts* to find the defendants liable under the securities laws. The Second Circuit's holding was cited soon thereafter by nearly all of the circuits for the proposition that fraud and deceit under the Exchange Act included the failure of a corporate insider to disclose material nonpublic information to a purchaser or seller before selling or buying a security.[203]

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198. Anna Driver, *U.S Government Drops 5 Ex-NYSE Specialist Cases*, REUTERS (Nov. 21, 2006), https://next.westlaw.com (follow "News" hyperlink; then search "U.S. Government Drops 5 Ex-NYSE Specialist Cases"; then click the second result) [https://perma.cc/F84K-JRWP].

199. Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 361 (1988).

200. 40 S.E.C. 907 (1961).

201. *Id.* at 912.

202. 401 F.2d 833 (2d Cir. 1968).

203. *See* Eisler v. Stritzler, 535 F.2d 148, 153 (1st Cir. 1976); Gold v. Sloan, 491 F.2d 729, 731 (4th Cir. 1974) (labeling *Texas Gulf Sulphur* as the maturation of Rule 10b-5); Swanson v. Am. Consumers Indus., Inc., 475 F.2d 516, 521 (7th Cir. 1973); Wessel v. Buhler, 437 F.2d 279, 282 (9th Cir. 1971); Kahan v. Rosenstiel, 424 F.2d 161, 172 (3d Cir. 1970); City Nat'l Bank of Fort Smith v. Vanderboom, 422 F.2d 221, 229–30 (8th Cir. 1970);

Moreover, the Second Circuit in *Texas Gulf Sulphur* articulated a test of what constitutes material information that would later be adopted by the Supreme Court. The *Texas Gulf Sulphur* Court held that material information includes "facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities."[204] This test was expressly adopted by the Supreme Court in *Basic v. Levinson*,[205] and the Court's opinion influenced how subsequent courts interpreted the disclosure duties of public companies under the securities laws.[206]

The Second Circuit was also one of the first courts to expand insider trading liability beyond corporate insiders. Unlike the *Texas Gulf Sulphur* defendants, Vincent Chiarella was not a corporate insider.[207] He was neither wealthy nor well connected—in fact, he was a working class individual employed by a printing firm, Pandick Press, to set the typeface and page layouts for various printer jobs, including merger agreements.[208] Through his position, however, Chiarella was exposed to highly sensitive and confidential information about mergers and acquisitions. Although the names of the buying and target corporations were never stated explicitly, Chiarella often was able to decipher the actual name of a target company from its code name. Knowing that the target company's stock price would rise after announcement of the merger, he bought stock in USM Corp. after deciphering the target company's name from five separate takeover bids for the company. Chiarella made a substantial profit, but the government indicted him on an insider trading theory.[209]

Chiarella argued that he could not be found liable for insider trading because he was not an insider of the company in which he bought stocks and had no fiduciary obligation to deal fairly with the sellers of the stock. Judge Irving Kaufmann, writing for the majority in *United States v. Chiarella*,[210] rejected his argument, reasoning that liability under the securities laws was not limited to corporate insiders per se but instead extended to all market insiders—that is, those who regularly receive material information not available to the public as a result of their employment. Chiarella's breach of a fiduciary duty he owed to his employer, who entrusted Chiarella with this sensitive information, was sufficient to sweep Chiarella within the ambit of the securities regulations. Judge Thomas Meskill, in dissent, argued that Chiarella could not be found

Britt v. Cyril Bath Co., 417 F.2d 433, 435, 437 (6th Cir. 1969); Kuehnert v. Texstar Corp., 412 F.2d 700, 702 (5th Cir. 1969).

204. *Texas Gulf Sulphur*, 401 F.2d at 849.

205. 485 U.S. 224 (1988); *see id.* at 238–39.

206. For example, *Basic v. Levinson* was not a case about insider trading; rather, it was about whether a company had a duty to disclose that they were in the midst of negotiating a merger agreement. *Id.* at 230.

207. Chiarella v. United States, 445 U.S. 222, 224–25 (1980).

208. *Id.*

209. *Id.*

210. 588 F.2d 1358 (2d Cir. 1978).

liable under securities regulations because there was no fraud[211]: Chiarella owed no duty to speak because he had no fiduciary relationship with USM Corp.'s stockholders. Judge Meskill ultimately won the day, as the Supreme Court reversed the Second Circuit's decision and Chiarella's conviction, relying on Judge Meskill's reasoning in his dissent.[212]

Although ultimately reversed, the Second Circuit's *Chiarella* decision would serve as the first seed for a second theory of insider trading liability—the "misappropriation theory." Unlike the classical theory of insider trading, liability under the misappropriation theory does not require that the individual be a corporate insider who breaches a fiduciary duty to her corporation by trading on the basis of material nonpublic information. Liability under the misappropriation theory is based on an individual's breach of a fiduciary duty to the source of confidential information that is subsequently traded upon. Indeed, Justice Stevens's *Chiarella* concurrence noted that the Supreme Court left open the question of whether insider trading liability could extend to instances where an individual misappropriates confidential information from an employer for personal benefit, even where that individual was not a "corporate insider." While the Supreme Court answered that question in the affirmative in *United States v. O'Hagan*[213] almost twenty years later, the Second Circuit had, by that time, already developed a well-plowed misappropriation theory jurisprudence.

If *Chiarella* was the seedling that laid the groundwork for the misappropriation theory, *United States v. Newman*[214]—the first case to explicitly adopt the misappropriation theory—was the tree that grew from it. James Newman was part of a group (along with Jacques Courtois, Franklin Carniol, and Constantine Spyropoulos) that, from 1973 through 1978, devised a scheme to use confidential information for the purposes of securities trading. Courtois and another individual, Adrian Antoniu, would misappropriate confidential information concerning proposed mergers and acquisitions from their employers, Morgan Stanley and Kuhn Loeb.[215] Courtois and Antoniu then would pass on that confidential information to Newman, a securities trader, who would pass the information to Carniol and Spyropoulos, both residents of foreign countries, who used the information to purchase securities through secret foreign bank accounts and trusts.[216]

Like Chiarella, Newman was not a corporate insider who fit within the classical definition of insider trading. The Second Circuit, accordingly, could have dismissed the charges against him on the ground that he owed no fiduciary duty to shareholders, as the district court had done. Instead, the Second Circuit panel took the opportunity to revisit the misappropriation theory, noting that the Supreme Court had not yet addressed whether insider trading liability could extend to corporate

211. *See id.* at 1373 (Meskill, J., dissenting).
212. *Chiarella*, 445 U.S. at 234–37.
213. 521 U.S. 642 (1997).
214. 664 F.2d 12 (2d Cir. 1981).
215. *Id.* at 15–17.
216. *Id.*

outsiders who misappropriated confidential information.[217] The court concluded that, by stealing information from his employer, Newman engaged in deceitful conduct subject to insider trading liability. Newman's act of profiting from that conduct by passing the stolen information along to others who would purchase securities based on that information, in the Second Circuit's opinion, involved a core violation of the securities laws.[218] The *Newman* decision would come to be seen as the first case to seriously develop and embrace the misappropriation theory of insider trading liability.[219] The House Report on the Insider Trading Sanctions Act of 1984 refers repeatedly to the misappropriation theory, citing *Newman*.[220] References to the misappropriation theory also appear in the legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988, where Congress "explicitly revised the private right of action provision for the purpose of giving standing to . . . traders injured by violations of the misappropriation theory."[221]

The Second Circuit expanded the scope of misappropriation liability in *United States v. Carpenter*,[222] where the court held that a breach of a fiduciary duty to an employer who owed a duty to other clients was not necessary to the misappropriation theory.[223] Rather, the circuit found that the misappropriation theory was premised on the fact that information was stolen—regardless of whether the employer had a fiduciary duty to keep information confidential. The Second Circuit thus successfully extended the power of the securities laws to govern not only corporate insiders, but any employee with access to material nonpublic information. *Carpenter* thus represents the final break from the traditional requirement that there exist some fiduciary duty between the trader and the target corporation.[224]

The facts of *United States v. Chestman*[225] caused the Second Circuit to rein in the expansion of the misappropriation theory. Robert Chestman was convicted of receiving and trading on material nonpublic information he received from Keith Loeb, husband to Susan, the niece of a wealthy

217. *Id.* at 16.

218. *Id.*

219. *See* United States v. O'Hagan, 92 F.3d 612, 621 (8th Cir. 1996) (noting that *Newman* was the genesis of the misappropriation theory).

220. H.R. REP. NO. 98-355, at 4–5, 13 n.20 (1983) ("[D]eceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust has consistently been held to be unlawful. The Congress has not sanctioned a less rigorous code of conduct under the federal securities laws.").

221. 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 6:2 (2015). The Second Circuit also applied this theory in *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), which involved an employee at a printing press who successfully deciphered the identities of several targets of different mergers and traded on that information. The Second Circuit affirmed his liability on the ground that he had traded on misappropriated (i.e., stolen) information.

222. 791 F.2d 1024 (2d Cir. 1986).

223. *See id.*

224. *See* United States v. Chestman, 947 F.2d 551, 566–67 (2d Cir. 1991) ("[W]e arguably did not break ranks with the traditional theory of insider trading until our holding in *Carpenter*.").

225. 947 F.2d 551 (2d Cir. 1991).

entrepreneur, Ira Waldbaum. Ira Waldbaum had substantial holdings in Waldbaum's, a large and successful grocery chain that was to be purchased by another company at a price double its current market value. Ira had informed his sister, Shirley, of the pending transaction, who, despite Ira's instructions to the contrary, told her daughter Susan of the transaction. When Susan told her husband, Loeb, about the upcoming transaction, he immediately informed Chestman, who thereafter purchased stock in Waldbaum's.[226] Chestman, unlike Carpenter, did not actually misappropriate any information—he only received that information from Loeb, who received it from his wife. As a result, the Second Circuit held that the misappropriation theory did not cover his conduct. The majority refused to hold that family members owe a fiduciary duty to one another. Thus, because Keith Loeb could not have breached a fiduciary duty to his family members, Chestman could not be held liable under the securities regulations.[227]

Judge Ralph Winter dissented. He contended that the court should have found that a fiduciary duty among family members could exist in the context of a family-controlled corporation, like Waldbaum's. Although rejected by the majority, Judge Winter's analysis ultimately won the day. His analysis was subsequently adopted by other circuits.[228] Furthermore, the SEC later amended the regulation concerning fraudulent and deceitful securities transactions and cited Judge Winter's analysis in creating a fiduciary duty not to disclose confidential information to other family members.[229]

The Second Circuit's recent decision in *United States v. Newman*[230] is likely to be just as influential. *Newman* concerned the appeal of two hedge fund managers, Todd Newman and Anthony Chiasson, who allegedly traded based on information about the quarterly earnings of Dell and NVIDIA that they received through a tipping chain.[231] Newman and Chiasson were several steps removed from the insiders who disclosed the information. Although the Supreme Court had previously held that the government was required to prove that a "tippee" knew that the "tipper" had breached his duty of confidentiality,[232] it had not addressed whether those who received the information also had to know the tipper himself benefited from the breach in order to be found liable. The Second Circuit reversed the defendants' convictions, holding that the government did indeed have to show that the tippee knew that the tipper benefited from the breach. The

226. *Id.* at 555.
227. *Id.* at 570–71.
228. *See, e.g.*, SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003).
229. *See* 17 C.F.R. § 240.10b5-2 (2009).
230. 773 F.3d 438 (2d Cir. 2014), *cert. denied*, No. 15-137, 2015 WL 4575840 (Oct. 5, 2015).
231. Tipping is traditionally where a corporate insider gives another individual, usually an outsider, material nonpublic information. A tipping chain occurs when the person who receives the information further disseminates the information to others who, in turn, transmit the information to others, and so on.
232. *See* Dirks v. SEC, 463 U.S. 646 (1983).

Second Circuit also articulated a narrower view of what could constitute a personal benefit than what the government had urged. It rejected the government's argument that mere friendship could suffice and held that the benefit received by the tipper "must be of some consequence."[233] With this decision, the Second Circuit significantly pruned the government's ability to prosecute remote tippees.[234]

D. Decades of Scandals: Insider Trading in the 1980s and the Dot-Com Era

Given the Second Circuit's jurisdiction over Wall Street, it is little surprise that many of the most notorious financial scandals of recent decades have found their way to the Second Circuit's docket. One of the most notorious was the Drexel Burnham Lambert insider trading scandal, a defining moment of the 1980s. The key player in the scandal was Michael Milken, the so-called "Junk Bond King," a Drexel executive with an outsized personality and ego.[235] Milken successfully revolutionized the non-investment-grade ("junk") bond market,[236] by pioneering a strategy in which corporate raiders issued junk bonds to finance corporate takeovers.[237] After corporate raiders (such as Ivan Boesky) issued junk bonds underwritten by Drexel, Milken would orchestrate a series of transactions designed to artificially prop up the value of the bonds and to conceal weaknesses in the underlying assets.[238] In a separate part of the scheme, Boesky and others often traded on nonpublic information and shared "tips" about impending mergers or acquisitions that could cause huge swings in the stock price.[239] Boesky, Milken, and several other key players (including Dennis Levine, Robert Freeman, and Martin Siegel) were all

233. *Newman*, 773 F.3d at 452.

234. Notably, the Supreme Court chose to let the Second Circuit's analysis remain good law, rather than intervene in this issue. *See Newman*, 2015 WL 4575840. Even though the Supreme Court typically grants "sixty to seventy percent" of petitions for certiorari from the Solicitor General, it denied the Solicitor General's request in *Newman*—deferring again to the Second Circuit's development of the law in this area. *See* Patricia A. Millett, *"We're Your Government and We're Here to Help": Obtaining Amicus Support from the Federal Government in Supreme Court Cases*, 10 J. APP. PRAC. & PROCESS 209, 216 n.18 (2009) (noting that the Solicitor General's petitions for certiorari are granted "roughly sixty to seventy percent of the time"). On January 19, 2016, however, the Supreme Court granted certiorari in *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), a Ninth Circuit case that rejected the Second Circuit's analysis in *Newman*. *Salman*, therefore, should resolve whether the Second Circuit's analysis in this area ultimately will stand.

235. *See* William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. CAL. L. REV. 783, 811 (2013) (describing how Milken presented a "clash of cultures between a white shoe Wall Street and a larger-than-life, upstart Jewish bond trader, and lurid tales of insider trading, bad toupees, partying, and excess").

236. *See id.* at 795.

237. *Id.*

238. *See id.* at 797–98 (noting that this arrangement, termed a "daisy chain" scheme, involves "an asset [that is] sold back and forth among the chain's members who book 'profits' on each sale even as the fundamental value of the asset does not appreciate").

239. *See generally* United States v. Mulheren, 938 F.2d 364 (2d Cir. 1991).

convicted of crimes involving illicit trading.[240] The Second Circuit was the final arbiter of their appeals (which were generally rejected).[241]

The Second Circuit also saw a wave of insider trading cases after the 2009 financial crisis, including the prosecution of Raj Rajaratnam, founder of the Galleon Group, and Rajat Gupta, a member of Goldman Sachs's board of directors.[242] On the afternoon of September 23, 2008, Goldman Sachs held a meeting of its board of directors to approve an investment from Warren Buffett of $5 billion in Goldman.[243] The company was set to announce the investment at 4:00 p.m. At 3:54 p.m., Gupta's assistant placed a call to Rajaratnam's direct line and connected him to Gupta. Rajaratnam then instructed several of his fellow traders to begin buying Goldman stock. The Galleon Group purchased $33 million worth of stock and made over $1 million when Goldman's stock rose nearly 7 percent the morning after the announcement.[244]

Gupta was convicted on four of six counts, including securities fraud, and was sentenced to twenty-four months' imprisonment.[245] Rajaratnam was convicted on nine counts of securities fraud and five counts of conspiracy to commit securities fraud,[246] and was sentenced to 132 months' imprisonment and ordered to pay over $60 million in fines—the largest sentence ever handed down in the history of insider trading prosecutions.[247] The Second Circuit upheld both convictions on appeal.[248] In the aftermath of the Great Recession, the federal courts in New York sentenced nearly 80 percent of convicted insider traders to prison and the median sentence rose from eleven months in the 1990s to two-and-a-half years in recent years.[249] The government, with the help of careful appellate review by the Second Circuit, had once again cracked down on the boldest wrongdoers in the aftermath of a severe recession.

240. *Id.* at 365.

241. *See, e.g.*, SEC v. Posner, 16 F.3d 520 (2d Cir. 1994) (denying Drexel's appeal of its conviction for illicit trading practices).

242. *See* Christopher P. Montagano, Note, *The Global Crackdown on Insider Trading: A Silver Lining to the "Great Recession,"* 19 IND. J. GLOBAL L. STUD. 575 (2012) (discussing the recent global crackdown on insider trading in the United States, China, and Europe).

243. United States v. Gupta, 747 F.3d 111, 117 (2d Cir. 2014).

244. *Id.* at 117–18.

245. *Id.* at 122.

246. United States v. Rajaratnam, 719 F.3d 139, 150 (2d Cir. 2013).

247. *Id.* at 151–52.

248. *Id.* at 160; *see also Gupta*, 747 F.3d at 140.

249. *See* J. Scott Colesanti, *Wall Street as Yossarian: The Other Effects of the Rajaratnam Insider Trading Conviction*, 40 HOFSTRA L. REV. 411, 423 (2011) (noting that "since 2009, the federal courts in New York have sent convicted insider traders to jail seventy-nine percent of the time" and "the median sentence for those so incarcerated has risen to approximately two and a half years . . . as opposed to . . . eleven and a half months between 1993 and 1999").

III. IMPORTANT BANKING LAW DECISIONS

Given New York's importance as a financial center,[250] the Second Circuit has handled not just securities regulation but a wide array of issues concerning the banking industry and the propriety of banks' activities. Disputes about the nature of banks and what they should be allowed to do are as old as the country itself.[251] In 1819, Justice John Marshall, writing for the Supreme Court in *McCulloch v. Maryland*,[252] recognized that "the happiness and prosperity of the nation so vitally depends" upon banks to facilitate commerce and industry.[253]

Many disputes about the powers and limitations of banks involve the Glass-Steagall Act of 1933, which attempted to improve the safety of commercial banks by precluding them from engaging in risky financing activities. Prior to the twentieth century, national commercial banks had been prohibited from underwriting securities.[254] But because many state banks were permitted by state law to underwrite securities, in the early part of the twentieth century, national banks could circumvent the prohibition on underwriting by affiliating themselves with state banks.[255] Congress approved such arrangements, with the blessing of the Comptroller of the Currency, through the McFadden Act of 1927.[256]

After the stock market crash of 1929, and the subsequent economic depression, approximately 5,000 banks failed—creating concerns that commercial banks had become too exposed to the risks of the stock market and the broader economy.[257] The Glass-Steagall Act of 1933 was designed to increase the safety of commercial banks by separating "Main Street" commercial banks from Wall Street investment banks. Commercial banks with federal deposit insurance were permitted to engage only in "the

250. *See* FDIC, MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY 9 (1987) (noting that the New York Free Banking Act initiated the free banking era and that the Act's ideas and language "subsequently were adopted by other state governments and the federal government"); Bray Hammond, *Free Banks and Corporations: The New York Free Banking Act of 1838*, 44 J. POL. ECON. 184, 184–209 (1936) (explaining how the Free Banking Act in New York established a "distinctly American system of banking" and describing the Act's adoption as "the most important event in American banking history").

251. Alexander Hamilton and Thomas Jefferson vehemently disagreed about the role and structure of banking institutions in America. *See, e.g.*, Alexander Hamilton, *Opinion on the Constitutionality of the Bank, February 23, 1791*, *in* THE REPORTS OF ALEXANDER HAMILTON 88 (Jacob E. Cooke ed., 1964) (discussing the importance of a national bank and arguing that Congress had authority to charter a national bank); Thomas Jefferson, *Opinion on the Constitutionality of a National Bank*, *in* THE PORTABLE THOMAS JEFFERSON 265 (Merrill D. Peterson ed., 1975) (arguing that the incorporation of a bank is outside the scope of congressional authority and discussing the dangers of a highly centralized national bank).

252. 17 U.S. 316 (1819).

253. *Id.* at 408.

254. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, STATE REGULATION OF BANKS IN AN ERA OF DEREGULATION 10 (1988).

255. *Id.*

256. BENTON E. GUP, TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 87 (2003).

257. *Modernization of the Glass-Steagall Act: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 100th Cong. 33 (1987) (statement of Donald A. Ritchie, Associate Historian, Senate Historical Office).

business of banking" and "closely related" activities,[258] and were expressly precluded from engaging in risky financing activities such as underwriting securities, owning stocks, or affiliating with firms "engaged principally" in underwriting.[259]

This legislation introduced difficult line-drawing problems. The broad language used in the statute left considerable room for federal banking regulators to determine what constitutes "the business of banking" and what activities were impermissible.[260] Although banking regulators strictly limited the activities of commercial banks in the decades following the passage of Glass-Steagall, starting in the 1980s there was a broad push to reduce unnecessary government regulation—which extended, under President Reagan's tenure, to a "comprehensive program of financial deregulation."[261] The financial industry of the late 1980s looked nothing like the one that existed when Glass-Steagall was first adopted after the stock market crash of 1929.[262] As Alan Greenspan, Chairman of the Board of the Federal Reserve, put it, "the financial system ha[d] evolved beyond the terms of our laws and [wa]s functioning without effective legislative guidelines."[263] In that context, federal regulators began to relax some of the restrictions on commercial banks that had prevailed since the Great Depression. In a trio of cases, the Securities Industry Association, a national trade association of broker-dealers, challenged decisions by federal banking regulators to allow commercial banks to engage in securities-related activities. The Second Circuit uniformly deferred to the judgment of the banking regulators on these issues.

For example, in *Securities Industry Ass'n v. Board of Governors of the Federal Reserve System*,[264] the Federal Reserve Board permitted Bank America Corporation to acquire the Charles Schwab Corporation—the nation's largest discount brokerage firm at the time.[265] In a decision later

258. Under section 16 of Glass-Steagall, commercial banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking." Pub. L. No. 73-66, 48 Stat. 162 (1933). Under the Bank Holding Company Act, a bank holding company may own a nonbanking entity where that entity was engaged in activities that were "closely related to the business of banking." Pub. L. No. 84-511, 70 Stat. 133 (1956).

259. *See id.*

260. *See id.*

261. President Ronald Reagan, Remarks on Signing the Garn-St. Germain Depository (Oct. 15, 1982), https://reaganlibrary.archives.gov/archives/speeches/1982/101582b.htm [https://perma.cc/4XVB-TFT8].

262. SUBCOMM. TELECOMMS. & FIN, 100TH CONG., IMPLICATIONS OF GLASS-STEAGALL REFORM 4 (Comm. Print 1988) (noting that the laws governing our financial services sector are fifty-five years old and "are not suited to a dynamic world economy that is guided by fast-paced transactions in financial instruments that were not even dreamed of when Glass-Steagall was enacted, and it is rife with inequities and inconsistencies").

263. *Role of Financial Institutions: Hearing Before H.R. Subcomm. on Telecomm. & Fin.*, 100th Cong. 9 (1988) (statement of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve).

264. 716 F.2d 92 (2d Cir. 1983).

265. Section 20 of Glass-Steagall provides in relevant part: "[N]o member bank shall be affiliated . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at

affirmed by the Supreme Court, the Second Circuit rejected the Securities Industry Association's challenge and upheld the Federal Reserve Board's determination.[266] The Second Circuit viewed Glass-Steagall as primarily intended to prevent banks from investing their assets in risky securities like stocks that could jeopardize the bank's solvency in the event of a market downturn.[267] Because Schwab acted only as an agent for customers, and did not commit its own capital to risky investments, and because Schwab's revenue from customers "depend[ed] solely on the volume of shares traded . . . not . . . the sale or purchase of specific securities," the Second Circuit agreed with the Federal Reserve Board that a commercial bank could acquire Schwab.[268]

Five years later, the Second Circuit upheld Federal Reserve Board orders allowing nonbank subsidiaries of bank holding companies to engage in certain underwriting activities. The Second Circuit concluded that its policy of deference toward the Federal Reserve supported upholding the Board's interpretation of Glass-Steagall as long as that interpretation was reasonable.[269]

Subsequently, in *Securities Industry Ass'n v. Clarke*,[270] the Second Circuit concluded that banks could issue mortgage pass-through securities—that is, securities created when a mortgage holder forms a pool of mortgages and sells shares in the pool to investors, a process known as securitization. Although mortgage pass-throughs were registered securities under securities law, the Second Circuit found that issuing the securities was not an impermissible underwriting activity but merely a convenient and useful means of carrying out the traditional "business of banking"[271]—raising capital through the securitization process, instead of through traditional deposit taking. Writing for the circuit, Judge Thomas Meskill reiterated the great deference that the Second Circuit gave to banking regulators on issues of this nature.[272] The deregulation that the Second

wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities." Pub. L. No. 73-66, 48 Stat. 162.

266. Sec. Indus. Ass'n v. Bd. of Governors of Fed. Reserve Sys., 716 F.2d 92 (2d Cir. 1983), *aff'd*, 468 U.S. 207 (1984).

267. *Id.* at 97–98.

268. *Id.* at 98.

269. Sec. Indus. Ass'n v. Bd. of Governors of Fed. Reserve Sys., 839 F.2d 47 (2d Cir. 1988). This decision had its detractors. Congressman Norman F. Lent noted after the decision, "Earlier this week, the U.S. Court of Appeals for the [S]econd [C]ircuit issued an opinion that significantly expands the authority of bank subsidiaries to engage in securities activities . . . lead[ing] me to ask, what are the proper roles of the banking agencies, the courts, and Congress in the Glass-Steagall debate?" *Role of Financial Institutions: Hearing on H.R. 2557 Before the Subcomm. on Telecomm. & Fin.*, 100th Cong. 437 (1988) (statement of Hon. Norman F. Lent, Member, Subcommittee on Telecommunications and Finance).

270. 885 F.2d 1034 (2d Cir. 1989).

271. *Id.* at 1043.

272. In a 1992 decision, the Second Circuit also limited the sweep of the securities laws as applicable to the business of banking, holding that "loan participations" (a transaction where a bank sells to third parties interests in a loan) were not securities. Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51 (2d Cir. 1992).

Circuit had allowed federal banking regulators to undertake ultimately culminated in the repeal of Glass-Steagall with the Gramm-Leach-Bliley Act in 1999.[273]

Although the Second Circuit has principally focused on questions of domestic banking law, given New York's status as the world's preeminent financial center, the circuit has occasionally weighed in on global banking affairs. The sovereign debt default involving Argentina is a recent example of a particularly important international banking case.[274] Argentina restructured its sovereign debt in 2005, persuading most bondholders to accept major write-downs to the principal value of the debt. A small minority of bondholders held out for full repayment, and, when Argentina refused to make further payments on their debt, the holdouts sued Argentina in New York for violating the pari passu clause of their debt contracts, which required Argentina to afford equal treatment to bondholders. The Second Circuit affirmed the district court's ruling that the pari passu clause precluded Argentina from paying only bondholders who had accepted write-downs, while refusing to pay the holdouts.

This case is a noteworthy testament to the importance of the Second Circuit not just in New York but globally. Although the case involved a matter of Argentina's national debt, the Second Circuit had jurisdiction over the dispute because Argentina waived its sovereign immunity and consented to the jurisdiction of the Second Circuit and trial courts in New York City. Such waivers are common in sovereign debt issues in emerging markets—reflecting the high esteem in which the Second Circuit and other New York courts are held all over the world.[275] Moreover, in the Argentina case, the Second Circuit explicitly acknowledged the sometimes symbiotic relationship between New York's judicial system and the city's success as a world financial center: rejecting policy arguments from Argentina that strictly enforcing the debt contract would "steer bond issuers from the New York marketplace," Judge Parker noted that, "On the contrary, our decision affirms a proposition [of freedom of contract] essential to the integrity of the capital markets."[276]

Whether because it has helped ensure the integrity of the securities market by helping to develop antifraud and insider trading law, or because of its flexible oversight of banking regulation, there can be little doubt that New York owes no small measure of its success to its robust judicial system and strong commitment to the rule of the law.[277] Just as Delaware's strong legal system has helped that state to maintain a preeminent position in the

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273. *See* 15 U.S.C. § 6801 (2012).

274. *See* NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2d Cir. 2012); EM Ltd. v. Republic of Argentina, 695 F.3d 201 (2d Cir. 2012), *aff'd sub nom.* Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 2250 (2014).

275. *See* W. Mark C. Weidemaier, *Sovereign Debt and Sovereign Immunity*, 2014 U. ILL. L. REV. 67, 69, 73–88.

276. NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230, 248 (2d Cir. 2013).

277. *Cf.* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001) (discussing the legal and market institutions necessary for an economy to develop a strong securities market).

field of corporations and trusts,[278] so too has the Second Circuit's jurisprudence helped to maintain investor confidence in New York as a leading world financial center.

278. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 668–72 (1974).