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

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

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

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

I.	Introduction	2
II.	Enforcement of Rules under the Exchange Act	9
III.	The SEC’s Rulemaking Power	22
IV.	The Adoption of Rule 10b-5	27

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V.	Disentangling Rule 10b-5 from Section 10(b)	30
A.	Section 10(b) and Private Actions: Fraud on the Market	33
B.	Section 10(b) and SEC Power.....	39
VI.	Conclusion.....	47

I. INTRODUCTION

The most important provision of the securities laws is not in any federal securities statute. It is Securities and Exchange Commission (“SEC” or “the Commission”) Rule 10b-5, adopted quietly and without any expectation that it would become very important. Nevertheless, Rule 10b-5¹ has become one of the best-known provisions of American law. “[I]t is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little.”²

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

¹ 17 C.F.R. § 240.10b-5 (2013).

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

³ 425 U.S. 185 (1976).

⁴ 15 U.S.C. § 78j(b) (2012).

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

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

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

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

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

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

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

While the Court has focused on the language of section 10(b) in determining the scope of prohibited conduct, it has considered external sources, including policy, in defining the elements and parameters of the private

in reading section 10(b). The Court's reading is unfortunately exemplified by *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,⁹ in which the Court rejected scheme liability under Rule 10b-5, notwithstanding the language of the rule that makes it unlawful "to employ any device, scheme, or artifice to defraud."¹⁰ According to *Stoneridge*, there is no such liability because section 10(b) does not prohibit this conduct, and "Rule 10b-5 encompasses only conduct already prohibited by § 10(b)."¹¹

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

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

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

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

⁹ 552 U.S. 148 (2008).

¹⁰ 17 C.F.R. § 240.10b-5(a).

¹¹ 552 U.S. 157 (2008).

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

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

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

¹³ See *infra* Part II.

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

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

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

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

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

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

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

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

¹⁹ 15 U.S.C. § 78ff(a).

making it “unlawful” to use manipulative or deceptive devices or contrivances in contravention of SEC rules. The criminalization of certain rule violations is an important function, but one very different from the function the Supreme Court assumes section 10(b) serves. The Court had it backward in *Hochfelder* when it looked for a limitation on Rule 10b-5 in “the power granted the Commission by Congress under § 10(b).”²⁰ Rule 10b-5 does not implement section 10(b); section 10(b) implements Rule 10b-5.²¹

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

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

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

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