Section 10(B) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach

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Few issues in the field of securities law have proved as controversial as the legitimacy and proper application of the implied private cause of action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and its regulatory counterpart, Rule 10b-5. The Private Securities Litigation Reform Act of 1995 was expected by many observers to bring about sweeping changes in the implied private cause of action, which critics charge has been abused by overzealous litigants bringing frivolous lawsuits. In his timely article, Professor Fallone argues that most of the Private Securities Litigation Reform Act's changes to the implied private cause of action are merely procedural in nature and fail to address the real problem: the scope of liability for securities fraud under Section 10(b) has been rendered incomprehensible by conflicting court decisions and is no longer consistent with the overall goals of the federal securities laws. The author calls for Congress to reassert control over the content of the implied private cause of action under Section 10(b) by codifying it.

Professor Fallone begins with an overview of the most recent securities legislation and an explanation of why it does little to resolve the ambiguities surrounding the implied private cause of action. He then chronicles the history of the cause of action, describing its elements as they currently exist and how they have evolved over the years. The author then points out specific problems arising from the elements of the cause of action having been left up to the courts, and how the common-
law process has resulted in an interpretation of the cause of action that is inconsistent with the overall goals of the federal securities laws. Finally, Professor Fallone recommends that Congress codify the cause of action employing a structuralist approach, a method of statutory construction which emphasizes consistency with the operating principles of a statutory scheme.

I. Introduction

On December 22, 1995, the U.S. Senate overrode President Clinton's veto and enacted the Private Securities Litigation Reform Act of 1995 (Act). The stated goal of this legislation was to redress the perceived abuse of shareholder litigation under Section 10(b) of the Securities Exchange Act of 1934 and its attendant regulation, Securities and Exchange Commission Rule 10b-5. A coalition of critics that included high technology corporations and accounting firms successfully lobbied to convince Congress that nonmeritorious "strike suits" brought under Rule 10b-5 were imposing unacceptable costs on legitimate businesses. These critics complained that high-tech companies and the professionals who advised them were too often the target of frivolous class actions alleging securities fraud, brought by a specialized segment of the plaintiffs' bar, and generating nuisance settlements of the class's claims conjoined with large awards of attorneys' fees. A Republican majority in Congress, eager to comply with the promise to enact litigation reform as part of its "Contract with America," responded with the most substantial amendments to the nation's securities laws since the New Deal.

3. As stated forcefully in the Joint Statement of the Conference Committee that sent the bill to President Clinton, "The private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their pockets by bringing abusive and meritless suits." See H.R. CONF. REP. No. 104-369, at 31 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 730.
6. Strike suits typically are lawsuits designed to take advantage of a corporate defendant's incentive to settle otherwise defensible claims in order to avoid the expense and uncertainty of litigation. They have been defined simply as lawsuits based upon few substantive facts. See William H. Lash III, Securities Law Reform: A Half Step in the Right Direction 2 (1995).
7. See Avery, supra note 1, at 339. In the context of securities litigation, it has been noted that "[p]rivate parties may... rationally pursue claims that have a relatively low probability of success because defendants have an incentive to settle in order to avoid the costs of defense or to avoid the small prospect of a very large adverse judgment." Joseph A. Grundfest, Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority, 107 Harv. L. Rev. 961, 969-70 (1994); see Avery Katz, The Effect of Frivolous Lawsuits on the Settlement of Litigation, 10 INT'L Rev. L. & Econ. 3, 4-5 (1990).
To a certain extent, the Act is part of a renewed congressional interest in securities regulation. Like a colossus rousing itself from a decades-long slumber, the 104th Congress erupted in a fury of activity that, at times, appeared motivated by a desire to rewrite the entire content of the federal securities laws. Not all of Congress's efforts over the last year were successful. For example, legislation introduced to repeal the Glass-Steagall Act\(^9\) lost its momentum and was eventually abandoned. However, on October 1, 1996, the 104th Congress finished work on ambitious legislation intended to redraw the boundaries between federal and state regulation of the securities industry.\(^10\) Among other things, provisions contained in the National Securities Markets Improvement Act of 1996\(^11\) preempt state regulation of the mutual fund industry, limit state oversight of investment advisory firms that manage in excess of $25 million, and reduce the role of state law in regulating the primary offerings of larger corporations.\(^12\) Therefore, the Act can be viewed as but one example of Congress's current infatuation with all things relating to securities.\(^13\)

However, in other respects the passage of the Act is one manifestation of a more particular scrutiny being directed toward the purpose, utility, and proper scope of the private cause of action for securities fraud. Members of Congress, the Supreme Court, and academia have all, in one form or another, contributed to a resurgent debate concerning the many facets of private litigation under Rule 10b-5.\(^14\) Whatever the outcome of this debate, it is apparent that, in the future, a private

13. The Securities and Exchange Commission is also engaged in a flurry of activity designed to make substantial changes in the regulation of the securities industry. The agency has advocated the repeal or simplification of a large number of existing regulations, and is studying the feasibility of shifting the focus of the 1933 Securities Act away from a system of registered offerings and toward a system of registered companies. See SEC Accepts Company Registration Report; Issues Concept Release for Comment, Sec. L. Daily (BNA), at 4 (July 25, 1996); SEC to Issue Concept Release on Company Registration Model, 28 Sec. Reg. & L. Rep. (BNA) 911 (July 26, 1996); Summary Section of Report of the SEC's Task Force on Disclosure Simplification, 28 Sec. Reg. & L. Rep. (BNA) 356 (Mar. 8, 1996); SEC Seeks Comment on Reducing Filings for Selling Securities, WALL ST. J., July 25, 1996, at C18.
plaintiff alleging securities fraud will have to shepherd her claim through a much different legal environment from the one that has persisted for the last fifty years.

This article posits that the current debate concerning the private cause of action for securities fraud has its origins in a kind of "federal common law." An examination of the private cause of action as developed by the Supreme Court reveals it to be a product of judicial legislation: the rules governing liability have been shaped by conflicting policy goals and abrupt changes in interpretive methods designed to mask political choices. Recent congressional efforts to ameliorate the perceived abuses of private securities litigation can achieve, at best, limited success toward their goal, because congressional reform largely leaves intact the preexisting judicial definition of the cause of action. In this sense, Congress completed only half of its job when it passed the Act.\footnote{Cf. LASH, supra note 6, at 14-16.}

A process whereby the federal courts, and not Congress, dictate the content of the securities fraud cause of action has allowed private litigation to develop in an incoherent manner and has encouraged overenforcement by the plaintiffs' bar. In addition, this process leaves the cause of action unusually vulnerable to shifts in judicial philosophy that bear no relation to the purposes served by the Securities Exchange Act. The result of using the common-law process to define the cause of action has been to create an internal inconsistency within Section 10(b) itself and a structural inconsistency between Section 10(b) and the remainder of the federal securities laws. These inconsistencies have developed slowly, over time, and they cannot be resolved by the judiciary other than by a similarly gradual process. An alternative solution, codification of the private cause of action, is therefore necessary in order to achieve more immediate reform. Ideally, this codification should take place at the legislative, and not administrative, level.

Part II of this article outlines recent political developments relevant to securities fraud jurisprudence and the reforms instituted by Congress in the Private Securities Litigation Reform Act. It concludes that the new law will have little effect on the scope of the cause of action as developed by the courts. Part III traces the development of the federal common law of securities fraud and summarizes the elements of the cause of action as currently defined. In part IV, this article critiques the federal common-law process as a method of giving content to the 10b-5 cause of action, arguing that the vagaries of judge-made law lead to unpredictability and internal inconsistencies in the scope of the cause of action that are particularly troublesome in the context of the securities laws. Finally, part V proposes the codification of the securities fraud cause of action in a manner consistent
with a "structuralist" interpretation of the securities laws. A struc-
turalist interpretation of the scope of the implied Rule 10b-5 cause of
action places primacy on basic principles that can be derived from the
express causes of action contained elsewhere in the securities laws.
Codification pursuant to these principles, rather than evolving policy
rationales or the plain meaning of the text of Section 10(b), is the
most appealing alternative available to address the deficiencies that
have developed in the cause of action.

II. RECENT POLITICAL DEVELOPMENTS RELEVANT TO SECURITIES
FRAUD JURISPRUDENCE

A. The Terms of the Debate

The current debate over the private cause of action for securities
fraud has been inspired in part by a general perception that our judi-
cial system is increasingly overburdened and abused. To the public at
large, litigation of all stripes often is seen to bestow little benefit to
any segment of society other than attorneys. 16 In the securities area,
the limits of government resources have long led policy makers and
courts to recognize the efficiencies realized by recruiting "private at-
torneys general" to assist in policing the securities markets. 17 As the
years have passed, however, certain segments of the plaintiffs' bar
have discharged their function as private attorneys general with a zeal
bordering upon obsession. Critics have charged that the number of
nonmeritorious securities fraud suits has increased substantially in re-
cent years. 18

Whether or not the number of frivolous securities fraud class ac-
tions has ballooned over time remains a matter of some dispute. Em-
pirical studies suggest that the size of a settlement in a securities fraud
action is determined primarily by the funds available in the defend-
ant's insurance pool, rather than by an analysis of the merits underly-
ing the plaintiffs' claims. 19 These studies suggest that the claims being

16. See generally Kenneth Lasson, Lawyering Askew: Excesses in the Pursuit of Fees and
Justice, 74 B.U. L. REV. 723 (1994) (examining negative public perception of lawyers and sug-
gest ing ways to improve it); Symposium on Civil Justice Reform, 42 AM. U. L. REV. 1245 (1993)
(discussing reform proposals for various aspects of civil justice system in light of public criticism);
21, available in LEXIS, News Library, Wklyst File (discussing the rise of trial lawyers as the most
powerful professional special interest group in American politics).
of the Senate Comm. on Banking, Hous. & Urban Affairs, 103d Cong. 10 (1993) (statements of
John G. Adler, Edward R. McCraken, Richard J. Egan & F. Thomas Dunlop, Jr.); see also LASH,
supra note 6, at 4 (citing Wyatt & Co. study); John C. Coffee, Jr., The "New Learning" on
asserted have little legal support and are brought primarily to obtain attorneys' fees as the prime component of a nuisance settlement. The Securities and Exchange Commission, however, has denied the existence of any recent litigation "explosion" with respect to securities fraud suits.\textsuperscript{20}

Even if the relative percentage of securities fraud suits in federal court has remained constant over time, other, less quantifiable, factors may have converged in recent years to magnify the burden that such suits place on the judicial system. For example, a rise in criminal prosecutions in federal courts has substantially reduced the time and resources available to the entire civil docket.\textsuperscript{21} In addition, the current percentage of the federal docket devoted to securities fraud cases may only be sustainable due to the demonstrated willingness of defendants in those cases to settle claims before trial—a predilection that may change as the legal environment facing those claims changes.

As a result, the potential overenforcement of the prohibition on securities fraud continues to occupy the attention of courts and policy makers. Even if the empirical evidence pertaining to a current litigation explosion is murky, many argue that the reform of the private securities fraud cause of action is justified solely due to the public perception of a looming crisis.\textsuperscript{23} Businesspersons and government regulators alike recognize the possibility that, at some point, the resources of the judicial system may be taxed beyond capability by prolonged attention to nonmeritorious suits and that, eventually, the legal costs borne by U.S. corporations in defense of such suits may grow to intolerable levels.\textsuperscript{24} For some observers, the debate concerning the proper scope of the private cause of action for securities fraud begins and


\textsuperscript{20} In June 17, 1993, testimony before the Senate Banking Committee, SEC Enforcement Division Director William McLucas asserted that the approximate aggregate number of securities cases in federal courts (including Commission cases) had not increased over the past two decades and that the increase in securities class action suits in the prior three years, while significant, did not constitute an "explosion." See SEC on 'Explosion' of Suits, \textit{Wall St. J.}, June 18, 1993, at B6. Professor Seligman argues that the relative constancy of the number of corporations named as defendants from year to year (an average of 123.5 different companies sued each year over a four-year period) belies the existence of any sudden onslaught of nonmeritorious claims. See Seligman I, supra note 14, at 444.


\textsuperscript{22} See also Steven P. Marino & Renée D. Marino, \textit{An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters}, 22 Sec. Reg. L.J. 115 (1994).

\textsuperscript{23} See Avery, supra note 1, at 340 (quoting congressional testimony of Professor Donald Langevoort); see also Grundfest, supra note 7, at 972-74.

ends with the goal of filtering out private suits that are inspired by benign conduct and that, therefore, impose high social costs while generating little or no deterrent benefit.\textsuperscript{25}

A second factor contributing to the growing debate over the private cause of action for securities fraud has been the Supreme Court's evolving approach toward statutory construction. Although the operative language of Section 10(b) of the Securities Exchange Act has remained the same since its enactment in 1934, the manner in which the Supreme Court interprets that language has changed. As a result, the Court has concluded that Section 10(b) operates within boundaries much different from those previously contemplated, thereby reopening questions concerning the parameters of securities fraud that many observers had long considered to be settled.\textsuperscript{26} For some critics of private litigation, this uncertainty concerning the content of the private cause of action provides an opportunity to "rewrite" the prohibition on securities fraud, while maintaining only the most basic outline of its traditional form.\textsuperscript{27} Indeed, the continued efficacy of the private cause of action altogether—once an unassailable premise—has even become part of the debate.\textsuperscript{28}

B. A Fertile Environment for Reform

Criticism of vexatious litigation under Rule 10b-5 is, of course, nothing new. Complaints have been made to Congress before, with little or no discernible effect. The characteristics and motivations\textsuperscript{29} of "strike suits" were so well known over the past two decades as to merit extensive commentary in textbooks and court opinions.\textsuperscript{30} However, in 1995, for the first time, several factors coalesced to overcome Congress's previous inertia on the topic of reforming private litigation under Rule 10b-5.

\textsuperscript{25} See id. at 1023-27.
\textsuperscript{27} See Grundfest, \textit{supra} note 7, at 1011-14.
\textsuperscript{28} See id. at 964-65; Grundfest, \textit{supra} note 14, at 727.
\textsuperscript{29} In the Joint Statement of the Conference Committee, lawmakers listed the following abusive practices that they found to be sufficiently prevalent in securities litigation as to merit corrective action:
(1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

First, the Republicans had recaptured control of the House of Representatives one year earlier and firmly controlled the legislative agenda for the first time in decades. Trial lawyers in general, and the plaintiffs' securities bar in particular, have long been counted among the leading financial contributors to Democratic members of Congress.\(^3\) It has been suggested that this financial support was responsible for Congress's failure to place high priority on securities litigation reform during the period when the Democrats controlled the legislative agenda.\(^3\) By coincidence or not, several wide-ranging bills to reform various aspects of the securities laws quickly began to move through Congress after the Republicans won control of the House.\(^3\)

Second, proponents of the legislation may have felt emboldened to finally address the recognized shortcomings of securities fraud litigation in light of the Supreme Court's increasingly restrictive interpretation of the scope of private lawsuits brought under Rule 10b-5.\(^3\)

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32. See Fantz, supra note 31, at A1 (stating that “business groups say lawyers have used their political influence and well-placed contributions to thwart reforms”).


34. Examples of restrictive legal rules adopted by the Court include the adoption of a new, shorter statute of limitations for 10b-5 actions that was given retroactive effect. See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991). The retroactive application of the Court's decision would have cleared the federal docket of a substantial number of securities fraud suits. See Harvey L. Pitt & Karl A. Groskaufmanis, Was the Lampf Quick Fix Constitutional?, NAT'L L.J., Dec. 7, 1992, at 16. Congress attempted to ameliorate the effect of the Lampf decision by statute, see 15 U.S.C. § 78aa-1 (1994), but the Supreme Court subsequently held the statute to be unconstitutional to the extent that it sought to prevent the retroactive application of the rule announced in Lampf. See Plaut v. Spendthrift Farm, Inc., 115 S. Ct. 1447 (1995); see also Kevin R. Johnson, Responding to the “Litigation Explosion”: The Plain Meaning of Executive Branch Primacy over Immigration, 71 N.C. L. REV. 413, 438 n.113 (1993). Most recently, the Court has restricted the substantive reach of the statute by eliminating aing and abetting liability and adopting reasoning which foretells the eventual demise of liability based on common-law principles of respondent superior. See Edward Fallone, The Clinton Court Is Open for Business: The Business Law Jurisprudence of Justice Stephen Breyer, 59 Mo. L. REV. 857, 879 n.112 (1994) (stating that “the Court's reasoning in Central Bank appears to signal the future demise of vicarious liability in private actions brought under Rule 10b-5’’); Ediberto Roman, Statutory Interpretation in Securities Jurisprudence: A Failure of Textualism, 75 Neb. L. REV. 401 (forthcoming 1996) (manuscript at 55, on file with University of Illinois Law
The influence on Congress of present judicial attitudes toward private securities litigation should not be underestimated. In the early history of securities fraud litigation, the federal courts adopted a broad interpretation of the conduct that qualifies as "fraud," thereby making it easy for an aggrieved investor to allege facts sufficient to support a cause of action. In the majority of its more recent decisions, the Supreme Court has pared back the reach of the Rule 10b-5 private cause of action. The legislative history of the Private Securities Litigation Reform Act evidences congressional approval of the Supreme Court's change in direction.

Finally, passage of the Act undoubtedly also was assisted by the fact that Arthur Levitt was Chairman of the Securities and Exchange Commission (SEC) at the time reform measures were introduced. Chairman Levitt gave the legislation his qualified support, and the endorsement of the Chairman went far to win over some wavering lawmakers. Many observers of the SEC were surprised at Chairman Levitt's position, because support of the bill appeared to be a change in direction for an agency that in the past had zealously defended the utility of private litigation as an aid to enforcement.

However, Chairman Levitt's reaction to the bill appears to be consistent with a basic shift in recent years in the manner in which the SEC views private litigation. Historically, the SEC has argued that private litigation should play an expansive role in the enforcement of antifraud rules. Under Chairman Levitt, the SEC has shifted gears and undertaken a coordinated effort to actively discourage "unnecessary" private litigation under the securities laws. The SEC has come to view abusive or nonmeritorious litigation as a significant threat to enforcement.

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36. See Steinberg, supra note 14, at 491-96.


39. Professor Grundfest notes that "the Commission has, since the dawn of reported litigation over the question, consistently urged that courts interpret Rule 10b-5 to support the broadest possible scope for an implied private right of action." Grundfest, supra note 7, at 977-78.

its mission of protecting investors, \(^{41}\) fearing that courts may react to perceived litigation abuses by adopting substantive restrictions on private actions that would work to the detriment of all investors. \(^{42}\) Therefore, curbing frivolous litigation is now seen by the SEC as a necessary strategic step in the effort to preserve current investor protections from further judicial pruning. \(^{43}\)

The debate over Congress's recent move to reform securities fraud litigation must be understood in light of the environment described above. Critics of the Act claimed that it effectively eviscerated the private cause of action under Rule 10b-5. \(^{44}\) Supporters of the legislation viewed it as a necessary vehicle for returning securities fraud litigation to its original, more noble, purposes. \(^{45}\) In reality, however, the most significant of the reforms embodied in the Act are purely procedural in character and do not affect the content or elements of the securities fraud cause of action in any significant way.

41. See Grundfest, supra note 7, at 1022 n.301 (noting that "a majority of the sitting Commission has stated that private securities fraud litigation poses a problem that should be addressed"). The make-up of the Commission has changed since the time of Professor Grundfest's remark, however.


43. In November, 1994, the SEC took the remarkable step of acting in an amicus capacity in support of a motion to dismiss a private plaintiff's securities fraud claim in district court. In a letter addressed to the defendant in the action, then-General Counsel of the SEC Simon Lorne stated that the complaint in Frank v. Cooper Industries, Inc., Civ. Action No. H-94-0280 (S.D. Tex.), was inadequate to plead the existence of a false or misleading representation. See Letter from Simon Lome, SEC General Counsel, to Cooper Industries, Inc., Houston, Texas (Nov. 8, 1994) (on file with the University of Illinois Law Review). In the course of presenting this view, Lome noted the general adverse effects of meritless securities litigation on the investing public:

> Such litigation can impose substantial unnecessary costs, including discovery expenses, attorneys' fees, and time lost by corporate management. These costs are ultimately borne in the case of a publicly held corporate defendant by the public shareholders. Another cost to public shareholders may be reduced information on which to base investment decisions if corporations, fearful of undue exposure to litigation, limit the extent to which they voluntarily disclose information. . . . The threat of meritless litigation may also affect adversely the efficiency of capital formation and the allocation of capital resources.

Finally, meritless litigation may adversely affect the development of substantive securities law, as courts either develop erroneous or unworkable securities law concepts or misapply correct securities law concepts in an attempt to receive what they perceive as vexatious litigation. Unfortunately, such developments adversely affect meritorious actions, whether brought by investors or the Commission.


C. The Private Securities Litigation Reform Act

The Act, as originally drafted, was intended to revolutionize the manner in which private actions are brought under Rule 10b-5. Early drafts of the legislation contained many procedural reforms, some of them novel in character, intended to discourage the filing of meritless claims. For example, the original draft of the House bill contained a "loser pays" system that would have required unsuccessful parties to reimburse the attorneys' fees of prevailing parties. Other provisions were intended to redefine the scope of conduct that could give rise to liability under Rule 10b-5. The original House bill would have eliminated liability for reckless conduct, thereby codifying a more restrictive scienter requirement than is currently applied. The same draft also would have required the plaintiff in a private cause of action to demonstrate actual knowledge of and reliance upon a misstatement, thereby eliminating the "fraud on the market" theory as a basis for liability under Section 10(b).

However, the final legislation, as it developed in congressional subcommittees and eventually in conference committee, largely confines itself to procedural reforms and avoids questions relating to the definition of fraudulent conduct. As it relates to the Securities Exchange Act, the law contains eight general reforms to private litigation. Few of the reforms relate in any meaningful way to the actual scope of liability to be imposed under Rule 10b-5.

1. Class Action Procedures

The Act contains procedural provisions designed to reduce the ability of the plaintiffs' bar to serve as the instigator of class action filings and to diminish the likelihood that owners of a small economic stake in the defendant corporation will become the class representative in a suit brought under Rule 10b-5. In furtherance of this goal, the Act requires all plaintiffs seeking to serve as representatives in class actions under the Securities Exchange Act to file sworn certifications stating, among other things, that they have reviewed the com-

46. See Avery, supra note 1, at 348.
47. See id.
48. "The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. Misleading statements will therefore defraud purchasers of stock even if the purchasers did not directly rely on the misstatements." Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986) (citation omitted), quoted with approval in Basic Inc. v. Levinson, 485 U.S. 224, 241-42 (1988).
49. See Avery, supra note 1, at 348.
50. The following discussion is limited to those aspects of the new law that directly affect securities fraud actions under the Securities Exchange Act. The Private Securities Litigation Reform Act also modifies the Securities Act of 1933 in several similar respects and contains an important modification to the Racketeer Influenced and Corrupt Organizations Act (RICO).
plaints, that they did not purchase stock at the direction of counsel in order to qualify as class representatives, and that they will not accept any payment for serving as class representatives. The Act also contains new procedures for the appointment of lead plaintiff in a securities class action and requires courts to presume that the plaintiff with the “largest financial stake in the relief sought” is the most appropriate lead plaintiff. In addition, Section 21D(a)(3) of the Act also provides that the lead plaintiff appointed under these procedures will be responsible for selecting and retaining lead counsel, and it contains provisions limiting the capacity of any person to serve as a lead plaintiff more than five times over any three-year period. All of these provisions serve to enhance the independence of the lead plaintiff from the attorney for the class.

The class action attorney’s influence and control over the course of the litigation is further diminished by provisions in the Act that limit the lead plaintiff’s recovery to a pro rata share of the final judgment, thereby reducing the prospect of the lead plaintiff being co-opted by class counsel. A provision that bars the filing of settlements under seal without “good cause” operates to discourage self-serving settlements on the part of counsel. All proposed and final settlements now must be disseminated to the members of the class in a new format designed to include all of the information deemed necessary to permit the class to evaluate the settlement. In addition, the lead attorney’s fees are capped at a “reasonable percentage” of the amount of damages and interest actually paid to the class, thus tying the attorney’s compensation more closely to the interests of the class.

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55. See id. § 21D(a)(4).
56. See id. § 21D(a)(5).
57. See id. § 21D(a)(7).
58. See id. § 21D(a)(6).
2. Delay of Fact Discovery

The Act contains provisions designed to delay the onset of litigation costs associated with fact discovery until after the defendant has had the opportunity to bring a motion to dismiss. Section 21D(b)(3)(B) provides that all discovery must be stayed during the pendency of a motion to dismiss, except for discovery of particular facts necessary to preserve evidence or to prevent undue prejudice to a party. By delaying fact discovery in this manner, the Act reduces the likelihood that either side will use the discovery process as a fishing expedition to bolster uncertain claims or as a bludgeon to coerce a settlement.

3. Imposition of Proportionate Liability

The Act alters the present system of joint and several liability in order to limit the circumstances under which one defendant is required to pay for injuries caused by the conduct of another defendant. A new system of "fair share" proportionate liability is instituted whereby, under certain circumstances, a particular defendant may be held liable solely for the portion of the judgment for which he is adjudged responsible. Proportionate liability applies where the defendant has been found liable for a non-knowing (i.e., reckless) violation of the Securities Exchange Act and, in addition, neither of the following scenarios exists: (a) the plaintiff has a net worth of less than $200,000 and is entitled to damages in excess of ten percent of her net worth, or (b) a codefendant is insolvent and cannot pay his share of damages. Joint and several liability remains the rule in most other circumstances, including cases where the defendants have been found liable for a knowing or intentional violation of the law.

4. Strengthening Rule 11

The Act strengthens the application of Rule 11 of the Federal Rules of Civil Procedure to private securities actions in order to better deter frivolous filings. The law now requires the court, upon final adjudication of the action, to enter findings in the record concerning each attorney's compliance with his or her obligations under Rule 11.

60. See Securities Exchange Act § 21D(b)(3)(B); see also Medhekar v. United States Dist. Court for the N. Dist. of Cal., 99 F.3d 325, 328 (9th Cir. 1996) (concluding that initial disclosure requirements under Federal Rule of Civil Procedure 26(a)(1) are subject to the Act's stay provisions).
in connection with the lawsuit. Where the court determines that the requirements of Rule 11 have been violated, the Act requires the imposition of sanctions, with the rebuttable presumption that sanctions will take the form of attorneys' fees and costs. In a class action, the court has the authority to require an advance undertaking from the attorney for the class to provide for the payment of any fees and expenses ultimately awarded under Rule 11.

5. Heightened Pleading Requirements

The Act heightens the pleading standards necessary in any complaint under the Securities Exchange Act that requires an allegation of the defendant's state of mind. The goal of the Act is to "establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits." Wherever liability is dependent upon the defendant having acted with a particular state of mind, the complaint must contain particularized facts that give rise to a "strong inference" that the defendant possessed the requisite scienter. It remains to be seen whether courts will interpret this new standard in a manner that is meaningfully different from previous pleading requirements.

In addition, the Act underscores the requirement that the plaintiff must plead and prove loss causation as an element of her case. Although the language of the Act states only that the plaintiff in a private action has the burden of proving loss causation, the legisla-
tive history of the Act evidences an intent to require an allegation of loss causation in the complaint itself. Therefore, a general allegation of transaction (or "but for") causation would appear insufficient to survive a motion to dismiss.

6. **New Measure of Damages**

The Act introduces a new method for calculating damages once liability has been ascertained in a case alleging securities fraud. The goal of Congress was to reduce the uncertainty involved in calculating damages using the market price of the security at issue at the time that the misrepresentation was publicly disclosed. Congress feared that the use of the market price in calculating damages often leads to an overestimation of the plaintiff's damages, due to the possibility that the price at the time of disclosure resulted from market conditions unconnected to the fraud. Therefore, the Act contains provisions that no damage award based on the market price of a security may exceed the difference between the purchase (or sale) price of the security and the mean trading price at which the security traded within the ninety-day period immediately following the disclosure of corrective information.

7. **New Statutory Duties for Auditors**

The Act imposes explicit new duties on corporate auditors to identify and report suspected illegal conduct. These duties include obligations to investigate possible illegalities that come to the attention of the auditor during its engagement, obligations to report instances of illegal conduct to the appropriate level of management and to the board of directors, and obligations, under certain circumstances, to report instances of illegal conduct to the Securities and Exchange Commission. These new auditor obligations serve as a counterweight to the procedural restrictions contained elsewhere in the Act. Procedural restrictions may be detrimental to an enforcement system that relies heavily on the threat of litigation by private attorneys general to deter fraud, but the new duties imposed on auditors indicate an overall attempt by Congress to compensate for these restrictions by shifting some of the enforcement burden toward independent accountants.

74. See id. at 741.
76. See id. § 10A.
77. See Phillips & Miller, supra note 24, at 1062-64.
8. New Safe Harbor for Forward-Looking Information

One of the most significant provisions of the Act creates a statutory safe harbor for the disclosure of forward-looking information.\(^7\) Congress acted to create this safe harbor out of fear that the prospect of abusive litigation has discouraged corporate managers from disclosing internal projections and similar forecasts to the marketplace.\(^7\) The Act's safe harbor applies to forward-looking statements made by a reporting company, its management or employees, or by auditors and underwriters engaged in its behalf.\(^8\)

Statements that qualify for the safe harbor cannot give rise to private liability if either of two tests is met. First, no private liability may be imposed for forward-looking statements made without actual knowledge that the statements were false or misleading.\(^9\) Second, no private liability may be imposed if the forward-looking statement is identified as such when made and is accompanied by meaningful cautionary language identifying important factors that could prevent the statement from becoming accurate.\(^8\)

In enacting the safe harbor provision, Congress expressly approved of two other safe harbors for forward-looking information that remain available under the Securities Exchange Act.\(^1\) Rule 3b-6 provides that forward-looking statements contained in a document filed with the SEC shall not be deemed fraudulent unless made or reaffirmed without a reasonable basis or disclosed in bad faith.\(^4\) In addition, the "bespeaks caution" doctrine holds that certain forward-looking statements are not actionable if accompanied by cautionary language because (1) such statements may be immaterial as a matter of law, and (2) plaintiffs are not entitled to justifiably rely upon such statements.\(^5\) The safe harbor contained in the Private Securities Litigation Reform Act is not intended to displace either one of these pre-existing protections for forward-looking statements.\(^6\)

D. What the Reform Act Does Not Do

The Act is actually change on a modest scale.\(^7\) Its most significant reforms are reforms of the procedural limitations placed on the

\(^7\) See Securities Exchange Act § 21E.
\(^9\) See Avery, supra note 1, at 355. The Act excludes statements contained in the financial statements of the company and statements made in connection with a tender offer or initial public offering from the protections of the safe harbor. See id.
\(^1\) See id.
\(^4\) See id.
\(^2\) See id.
\(^6\) See 17 C.F.R. § 240.3b-6 (1995).
\(^3\) See Avery, supra note 1, at 344.
\(^7\) In the wake of the Reform Act's passage, one attorney observer has noted that new securities fraud filings in federal court have not slowed significantly and "to a large extent, it's
class action plaintiff and her attorney in a securities fraud lawsuit. The
primary goals of the legislation are transparent: to allow more claims
to be dismissed at the pleading stage, to place greater control over
litigation in the hands of large shareholder plaintiffs (as opposed to
the owners of single shares and their "strike suit" lawyers), and to
enact penalties for filing a lawsuit without an adequate factual inves-
tigation of the asserted claims. With the exception of the safe harbor
provisions, the Act could well have been entitled "The Class Action
Reform Act." Most of its goals could have been addressed via
changes to the Federal Rules of Civil Procedure as opposed to amend-

Despite the passage of the Act, it is readily apparent that most of
the preexisting judge-made law concerning the scope of the Rule 10b-
5 cause of action remains untouched. The Act does touch upon the
scope of liability in the following ways: (1) the previously recognized
existence of loss causation as a separate element of the plaintiff's case
is reaffirmed; (2) the measure of damages and the application of pro-
portionate liability are modified for certain cases; and (3) one change
to existing standards of liability is effectuated through the creation of
a safe harbor for forward-looking statements.

The Act purposefully avoids defining the state of mind required
for imposition of liability for securities fraud. It leaves for another
day the issues raised by the "fraud on the market" theory. The sole
meaningful change to the scope of conduct giving rise to liability is the
creation of a new safe harbor of limited availability, which may act to
foreclose liability under some circumstances where the judicially cre-
ated "bespeaks caution" doctrine does not.

By failing to do little more than fiddle with the elements of the
cause of action as currently defined, the Act avoids the fundamental
question underlying recent Supreme Court jurisprudence in this area:
What types of conduct should give rise to a private cause of action
under Section 10(b) and Rule 10b-5? Although the new legislation
will make it more difficult for certain types of "professional plaintiffs"
and their attorneys to assert claims, it will have little effect on the
ability of plaintiffs in general to recover under a law whose boundaries


88. See Avery, supra note 1, at 337, 369-71.
89. See Coffee, supra note 70, at 989-96 (discussing ambiguities concerning the extent to
which the new statutory safe harbor provides protections beyond the bespeaks caution doctrine); see also Wallman Cites Lack of Consensus Within SEC on Safe Harbor Disclosure, 28 Sec. Reg. & L. Rep. (BNA) 1368-69 (Nov. 8, 1996) (same).
III. The Course of Federal Common Law Under Section 10(b)

A. Central Bank of Denver as Revisionist History

In its 1993-94 Term, the Supreme Court decided Central Bank of Denver v. First Interstate Bank of Denver. The decision, holding that aiding and abetting liability was not available in a private action brought under Rule 10b-5, surprised many who had been following the case. On the surface, at least, the ruling was unexpected because the Court's holding pertaining to the existence of aiding and abetting liability was contrary to the holding of every circuit court to have decided the issue.

An equally important, if less obvious, aspect of the case was the manner in which the majority opinion characterized the Supreme Court's prior Rule 10b-5 jurisprudence. In the eyes of the majority, all of the Court's prior cases interpreting the private cause of action could be categorized in one of two fashions: (1) cases going to the scope of liability under Section 10(b) or (2) cases interpreting the elements of the cause of action. The majority opinion stated that the Court has consistently considered itself bound by the language of Section 10(b) when considering whether to expand the scope of private

90. It is unrealistic to expect federal judges to police abusive securities fraud litigation solely through procedural mechanisms such as Rules 9(b) or 11 of the Federal Rules of Civil Procedure and to leave the substantive contours of liability untouched. But cf. Cunningham, supra note 42, at 1445 n.149. To a great extent, the parties before the court frame the issues to be decided. A judge faced with a claim that he or she perceives to be without merit may not wish to punish the attorney for arguing a good faith extension of the law, but nonetheless may be influenced in deciding the substantive question at issue by a desire to foreclose similar arguments in the future.

91. Cf. Avery, supra note 1, at 377 (concluding that the Act "contents itself with ... peripheral matters").


93. See id. at 191-92.


95. See 511 U.S. at 192 (Stevens, J., dissenting); see, e.g., Roberts v. Peat, Marwick, Mitchell & Co., 857 F.2d 646, 652 (9th Cir. 1988) ("Aiding and abetting is itself a violation of Section 10(b) and Rule 10b-5."); cert. denied, 493 U.S. 1002 (1989); Congregation of the Passion v. Kidder Peabody & Co., 800 F.2d 177, 183 (7th Cir. 1986); In re Atlantic Fin. Management, Inc., 784 F.2d 29, 34-35 (1st Cir. 1986) (Breyer, J.), cert. denied, 481 U.S. 1072 (1987).
liability to reach certain conduct. In contrast, the Court explained that in the interpretation of the elements of the 10b-5 cause of action, it has attempted to infer how Congress would have defined a scheme of private liability along the lines of the express causes of action contained in the securities laws. In the latter task, the Court conceded that it has allowed its decisions to be informed by common-law fraud principles and public policy rationales external to the text of Section 10(b).

In the majority’s view, the question of aiding and abetting liability fell within the first category of cases. Because the language of Section 10(b) does not expressly prohibit conduct that aids or abets a primary violation of the statute, the Court held that no private liability may be imposed for such conduct. In the familiar offhand tone used by appellate courts that want to add rhetorical weight to a dubious assertion, the majority opinion suggested that the result in Central Bank of Denver was “uncontroversial” and should have been obvious to anyone who had bothered to read its prior precedent.

In reality, the Court’s precedent is not subject to such a facile interpretation. Prior case law does not exhibit clearly distinct methodologies being applied to cases involving the scope of prohibited conduct versus cases defining the elements of a cause of action. It is true that the Supreme Court has often suggested that the scope of liability under any provision of the securities laws cannot be determined without reference to the language of the statute. However, despite occasional warnings that the Court would refuse to read Section 10(b) “more broadly than its language and . . . statutory scheme reasonably permit,” the scope of liability under the implied private cause of action for securities fraud has long been informed by policy rationales and other grounds of decision unconnected to the actual text of the statute.

97. See id.
98. See id. at 186-87.
99. See id. at 177-78.
100. The majority opinion states:
We reach the uncontroversial conclusion, accepted even by those courts recognizing a § 10(b) aiding and abetting cause of action, that the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation.... It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text.

Id.
103. See Alan R. Bromberg, Aiding and Abetting: Sudden Death and Possible Resurrection, Rev. Sec. & Commodities Reg. (McGraw Hill) 133, 136 n.28 (Aug. 1, 1994); Michael J. Kaufman, Mending the Weathered Jurisdictional Fences in the Supreme Court’s Securities Fraud Decisions, 49 SMU L. Rev. 159, 173-74 (1996); Donald C. Langevoort, Words from on High About Rule 10b-5: Chiarella’s History, Central Bank’s Future, 20 Del. J. Corp. L. 865, 886-87 (1995); Steinberg, supra note 14, at 494-96. As a result of its determination that the issue presented went to
For example, in *Blue Chip Stamps v. Manor Drug Stores*,\(^{104}\) the Court defined the class of potential plaintiffs with standing to bring a claim in a private action under Section 10(b). The Court held that only actual purchasers or sellers of securities have standing to bring a claim.\(^{105}\) By implication, *Blue Chip Stamps* restricted the scope of conduct that would be actionable under the statute: an individual cannot be held liable for a misleading statement or omission that merely dissuades someone else from purchasing or selling a security.

*Central Bank of Denver* states that prior decisions like *Blue Chip Stamps* going to the scope of liability under Section 10(b) have been analyzed solely by reference to the plain meaning of the statutory language.\(^{106}\) However, had the Court in *Blue Chip Stamps* actually utilized the text-based methodology suggested by the *Central Bank of Denver* majority, it might have reached a different result. Several interpretive questions would arise under such a text-based approach to *Blue Chip Stamps*.

Did a “purchase or sale” occur? The answer is yes, for the complaint is based on the plaintiff’s exclusion from a transaction that eventually occurred, albeit with a different purchaser.\(^{107}\) Is it necessary for the plaintiff to have actually purchased or sold securities herself in order to have been “deceived?” The answer is no, because the plain meaning of the word “deceit” would appear to include instances where the defendant’s actions dissuaded the plaintiff from participating in a profitable securities transaction that took place between other parties.\(^{108}\) Was the deception “in connection with” the purchase or sale that actually took place? The answer is yes, because the entire purpose of the deception was to exclude the plaintiff from the transaction.\(^{109}\) Therefore, the plain meaning of the statutory language appears to be violated by the conduct at issue.\(^{110}\)

\(^{104}\) 421 U.S. 723 (1975).

\(^{105}\) See id. at 731.

\(^{106}\) See 511 U.S. at 170-74.

\(^{107}\) Cf. Holmes v. Securities Investor Protection Corp., 503 U.S. 258, 283 (1992) (O’Connor, J., concurring) (stating that use of word “sale” in RICO civil cause of action need not be read to require that the plaintiff be a party to an executed sale).

\(^{108}\) Cf. *Blue Chip Stamps*, 421 U.S. at 770 (Blackmun, J., dissenting) (“The facts of this case, if proved and accepted by the factfinder, surely are within the conduct that Congress intended to ban.”).

\(^{109}\) Cf. id. at 764-65, 770 (Blackmun, J., dissenting).

\(^{110}\) The majority opinion in *Blue Chip Stamps* appears to recognize that its holding will operate to eliminate a cause of action on behalf of “plaintiffs who have in fact been damaged by violations of Rule 10b-5.” *Id.* at 743. But see id. at 733 n.5 (suggesting that the statutory language is not violated because fraudulent offers do not constitute a “sale” and because nonpurchasers cannot be defrauded “in connection with” a sale). The conclusion that the standing requirement of *Blue Chip Stamps* serves to bar claims that would otherwise fall within the statutory language of Section 10(b) is further supported by the observation, made elsewhere by a
In contrast, the actual holding in *Blue Chip Stamps* requires that the plaintiff be a party to a completed purchase or sale in order to have standing. This holding goes beyond the limitations inherent in the statutory language, and to the extent that it does so, it is premised upon policy rationales relating to problems of proof.111 A lawsuit seeking to recover for the plaintiff's fraudulently induced inaction would, of necessity, rely on the plaintiff's own testimony to a great degree.112 Defendants would have little objective evidence available with which to rebut such testimony.113 Because it is a simple matter for anyone to claim, with the benefit of hindsight, that she would have acted differently had certain facts or assumptions been disclosed, the potential for abusive litigation is increased where liability is allowed on the basis of inaction.114 These concerns, and not the construction of the statutory language alone, influenced the Supreme Court in its determination that the plaintiff must actually participate in a transaction involving the securities that form the basis of the misstatement or omission before liability may be imposed.115 Therefore, the majority in *Blue Chip Stamps* explicitly recognized the propriety of using policy considerations to flesh out the contours of the private cause of action, even under circumstances where strict adherence to the statutory text might lead to a different result.116

Similarly, in *Santa Fe Industries, Inc. v. Green*,117 the Court used policy rationales in addition to the statutory text to limit the cause of action's scope of liability by excluding breaches of fiduciary duty from the reach of Rule 10b-5.118 The *Santa Fe* Court ruled that "deception," as the Court understood the term, did not include conduct by corporate management that constituted nothing more than a breach of duty under state law.119 The Court devoted no more than a conclusory two-paragraph discussion to the construction of the statutory language.120 A much longer discussion was devoted to the justification of its holding on the basis of policy rationales: it would defy congressional intent to allow Section 10(b) to be used to police actions that were essentially violations of fiduciary duty under state law, and

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111. See *United States v. Bryan*, 58 F.3d 933, 947 n.11 (4th Cir. 1995) (citing later characterizations of the *Blue Chip Stamps* opinion as a policy-driven holding).
112. See *Blue Chip Stamps*, 421 U.S. at 734-35.
113. *See id.* at 742.
114. *See id.* at 739-47.
115. *See id.* at 754-55.
116. *See id.* at 723.
118. *See id.* at 477. While stating that the language of the statute was sufficiently clear to be dispositive on the issue presented, the Court went on to note "additional [policy] considerations that weigh heavily against permitting a cause of action under Rule 10b-5 for the breach of corporate fiduciary duty." *Id.*
119. *See id.* at 474.
120. *See id.*
to permit such a broad scope of liability would encourage vexatious litigation. Once again, had the Court applied a purely text-based approach to the question of what conduct gives rise to liability under Section 10(b), it would have reached a different result. Indeed, other decisions by the federal courts have read the term "deception" more broadly than the Supreme Court's relatively brief discussion in *Santa Fe* would indicate.

For example, in *Chiarella v. United States*, the Supreme Court held that a preexisting fiduciary duty is necessary before imposing criminal liability under Section 10(b) for insider trading, strongly suggesting that the source of such a duty may be found in state law. It has been observed, however, that state law did not typically incorporate a duty to disclose in the insider trading context. To a certain extent, the Court in *Chiarella* appears to have used state law as an analogy for delimiting the scope of a federal duty, rather than as an independent legal standard incorporated into Section 10(b). In subsequent cases outlining the scope of insider trading liability, the lower federal courts have followed the lead of *Chiarella* and have used the fiduciary duties owed by insiders to shareholders to define conduct violative of Section 10(b) and Rule 10b-5. Circuit court decisions adopting the "misappropriation theory" of insider trading have gone further, reasoning that the "deceptive" conduct prohibited by Section 10(b) should be defined to encompass conduct violative of any of the defendant's state law duties, not just the duties owed by a corporate insider.

Two competing strains of precedent have therefore developed. In contrast to the narrow reading of "deception" announced earlier in *Santa Fe*, which rejects the existence of a uniform federal fiduciary duty under Section 10(b), the insider trading cases employing the misappropriation theory have, until recently, given the same word a broader and equally plausible construction that creates federal duties on the basis of state law in order to define the boundaries of prohib-

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121. See id. at 478-79.
125. See id. at 199.
ited conduct. If these lower court decisions constitute an unwarranted extension of the scope of liability under Section 10(b), the Supreme Court has only itself—and its seemingly inconsistent interpretation of the same language in *Chiarella* and *Santa Fe*—to blame. As with *Blue Chip Stamps*, the analysis utilized in the *Santa Fe* case cannot be explained exclusively on the basis of the statutory text and, therefore, it does not fit neatly into the construct outlined in *Central Bank of Denver*.

Not only is the analytical approach set forth in the *Central Bank of Denver* case an inaccurate description of prior precedent, it fails to anticipate the possibility that some aspects of Section 10(b) cannot be categorized exclusively as involving either the scope of liability or an element of the plaintiff's case. For example, the one indication within the text of Section 10(b) that reveals Congress's view of the breadth of that section is the language requiring deceptive conduct, however defined, to be "in connection with" the purchase or sale of a security. The federal courts have long struggled with this phrase. Is this language a congressional indication of the scope of liability under the statute? Or does it state a required element of the plaintiff's case? This language does not appear to fall clearly within either of the two categories posited by the Court in *Central Bank of Denver*. Therefore, it is unclear which of the two alternative interpretive methodologies described in *Central Bank of Denver* should be applied in order to give content to the phrase.

A different result follows depending upon how the issue is categorized. Most courts considering the "in connection with" language have treated it as a relatively undemanding element of the plaintiff's case. It has sometimes been interpreted expansively on the basis of policy rationales designed to further the remedial purposes of the securities laws. One formulation of the element along these lines, employed at least once by the Supreme Court, is that in order to establish that the fraud was "in connection with" the subject transaction, the plaintiff need only show that the fraudulent conduct "touched" the purchase or sale of the securities.  


129. See Langevoort, supra note 103, at 887.


131. See Loss & Seligman, supra note 130, at 850-52.

132. See Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971). The case involved a seller of Treasury bonds who received full value for the bonds, but who was defrauded out of the proceeds. See id. at 8-9. The Court essentially held that the fraud need not go to the actual security purchased or sold in order to give rise to a cause of action. See also
However, taking its cue from *Central Bank of Denver*, a panel of the Fourth Circuit in *United States v. Bryan* \(^{133}\) recently treated the “in connection with” language contained in the statute as a limitation upon the permissible scope of liability under Section 10(b). \(^{134}\) The court in *Bryan*, obviously influenced by the more recent dictates of the Supreme Court, sought to interpret this language based solely upon the plain meaning of the text. The *Bryan* court concluded that the “in connection with” language imposes a type of privity requirement between the fraudulent actor and the person deceived before the statute can be violated. \(^{135}\) A panel of the Eighth Circuit recently reached the same conclusion in *United States v. O'Hagan*. \(^{136}\)

Although *Bryan* and *O'Hagan* are insider trading cases, their text-based interpretations of Section 10(b) rely upon, and are presumably applicable to, cases alleging securities fraud in general. However, any holding that Section 10(b) does not reach conduct by those who lack privity with the plaintiff is contradicted by countless previous securities fraud cases that have rejected a privity requirement. \(^{137}\) The point is not that *Bryan* and *O'Hagan* are rightly or wrongly decided. The significance of these cases is that they vividly demonstrate how drawing a distinction between statutory language defining the scope of liability under Section 10(b) and statutory language defining the elements of the cause of action, as required by *Central Bank of Denver*, is potentially outcome-determinative.

Ultimately, the distinction between the scope of prohibited conduct under the cause of action, on the one hand, and the interpretation of the elements of that cause of action, on the other, is a fine one which may be incapable of precise definition. The majority opinion in *Central Bank of Denver* does not attempt to provide a basis for differentiating between these two categories. However, the consequence of this distinction is to employ one of two very different methods of interpretation. The utility of any interpretive methodology for Section

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134. See id. at 949-50, 959. The *Bryan* court's holding rejected the use of the misappropriation theory as a means of defining the boundaries of the prohibition against insider trading. See id. at 944, 952; see also United States v. O'Hagan, 92 F.3d 612, 620 (8th Cir. 1996), cert. granted, 117 S. Ct. 759 (1997).
135. *Bryan*, 58 F.3d at 950 n.17, 952; see also *O'Hagan*, 92 F.3d at 618. The *Bryan* court also suggested that the plain meaning of the word “deception” limits a private plaintiff under Section 10(b) to a purchaser, seller, investor or other person with “a similar stake in an actual or proposed securities transaction.” *Bryan*, 58 F.3d at 946.
136. 92 F.3d at 618.
137. See Basic Inc. v. Levinson, 485 U.S. 224, 228 (1988); Superintendent of Ins., 404 U.S. at 9; McGann v. Ernst & Young, 95 F.3d 821, 823 (9th Cir. 1996); Baretge v. Barnett, 553 F.2d 290 (2d Cir. 1977); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-62 (2d Cir. 1968).
10(b) that allows courts to depart from prior precedent on the basis of a seemingly arbitrary categorization is doubtful.

As one might have expected, the history of securities fraud jurisprudence is somewhat messier than the Central Bank of Denver analysis would have us believe. Perhaps the most damning criticism of the Supreme Court's majority opinion in that case is that it attempts to recharacterize earlier precedent in order to conform it with a newly announced—and very different—method of interpreting Section 10(b). At most, the Supreme Court's decision represents an unjust attempt to redefine the legal rights available to defrauded investors in light of current judicial attitudes. At the very least, judicial candor requires that the majority recognize a major shift in its method of statutory analysis in cases involving securities fraud. In the section that follows, this article attempts to sketch an alternative perspective of the development of the securities fraud cause of action, in contrast to the characterization of prior precedent contained in Central Bank of Denver.

B. An Alternative History: How Common-Law Decision Making Has Defined the Contours of the Rule 10b-5 Cause of Action

The federal courts have recognized an implied private right of action under Section 10(b) and Rule 10b-5 for over 50 years. The cause of action was inferred by the courts despite the lack of any language in either Section 10(b) or Rule 10b-5 addressing the subject of private lawsuits and in the absence of any evidence that Congress intended to allow private lawsuits based on violations of Section 10(b). The originators of Rule 10b-5, promulgated by the SEC in 1942, were similarly oblivious to its potential use by private litigants. Therefore, the content of the private cause of action for securities fraud is largely the product of "federal common law."


142. See id. at 195-96; see also Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (comments of Milton Freeman); Grundfest, supra note 7, at 979-80. Private litigation under Rule 10b-5 has been famously described by Chief Justice Rehnquist as a "judicial oak" that has grown from a "legislative acorn." See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).
1. Importation of Common-Law Elements to Define Securities Fraud

An analysis of the development of the federal common law of securities fraud must begin with the language of Section 10(b) and Rule 10b-5. The language of each source of the implied right is similar and equally unhelpful. In terms that are both vague and broad, these provisions prohibit fraud and deception in connection with the purchase or sale of a security. Beyond the narrow purpose of eliminating fraudulent practices in connection with securities transactions, it appears that the broader purpose behind both Section 10(b) and Rule 10b-5 is to complement the mandatory disclosure system implemented by the remaining provisions of the 1933 and 1934 Securities Acts. If the overlay of federal law contained within the two Securities Acts operates as designed, it works as a whole to provide investors with protection beyond the common law by promoting the full disclosure of those facts essential to the evaluation of an investment opportunity.

The actual language of Section 10(b) prohibits "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Courts have long recognized that the word "manipulation" is almost a term of art in the securities context and that Congress had specific practices in mind when it chose to condemn manipulative conduct in this section. Therefore, to the extent that the language of Section 10(b) reaches unsavory conduct connected to a securities transaction that is beyond the scope of manipulation, the statute reaches only conduct that can be classified as deceptive.

Because Congress—either intentionally or through oversight—included no express provision for a private cause of action under Section 10(b), courts hearing private lawsuits under the section have been forced to define for themselves just what constitutes deception in connection with the purchase or sale of a security. In performing this task, the federal courts are constrained by basic constitutional limits.

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143. See Touche Ross & Co. v. Redington, 442 U.S. 560, 568 (1979); Ernst & Ernst, 425 U.S. at 197.

144. See Cunningham, supra note 42, at 1413 (stating that "the fundamental purpose of the federal securities laws and their system of mandatory disclosure" is to eliminate fraud); Seligman I, supra note 14, at 440; Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 STAN. L. REV. 385, 385-86 (1990).


147. See Santa Fe Indus., Inc. v. Green, 430 U.S. at 462, 476 (1977). The term "manipulative" refers to "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." Ernst & Ernst, 425 U.S. at 199. It has been used to refer to practices such as wash sales, matched orders, or rigged prices. See Santa Fe, 430 U.S. at 476.
on their authority. The elements of the plaintiff’s case, however defined, cannot allow recovery under Section 10(b) on the basis of conduct that is not somehow deceptive. To do so would clearly cross the line from judicial interpretation to lawmaking.

The interpretation of Section 10(b) is made all the more difficult by the fact that the text of the statute “does not forbid anyone from doing anything.” Congress left to the SEC the task of defining the actual manipulative and deceptive conduct that would constitute a violation of the statute. Therefore, in order to further define the parameters of the private right of action, reference must be made to Rule 10b-5 as promulgated by the SEC pursuant to the authority granted to the agency by Section 10(b).

In its broadest terms, Rule 10b-5 prohibits “any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.” However, it is a basic tenet of administrative law that the reach of Rule 10b-5 as applied cannot extend to conduct that falls outside of the boundaries of the deceptive conduct that Congress authorized the agency to police under Section 10(b). The Supreme Court has not hesitated to strike down interpretations of Rule 10b-5 that exceed the scope of the authority granted by Section 10(b).

Therefore, the interpretive task faced by a court called to construe the language of Section 10(b) and Rule 10b-5 is a daunting one. In order to give content to the elements of a private right of action under 10b-5, federal courts have been forced to look to other areas of the law. Because the conduct that Congress sought to regulate in the securities acts involves, in essence, a commercial transaction, it seems logical that the federal courts chose to borrow the elements of a Rule 10b-5 action from the elements of common-law fraud. State courts

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148. With the exception, of course, of conduct that satisfies the relatively narrow definition of “manipulative” conduct.
149. The Supreme Court’s hostile attitude in recent years toward arguments in favor of creating new implied private rights of action would seem to suggest that the very act of expounding upon the boundaries of preexisting implied causes of action comes very close to crossing that same line. However, due to principles of stare decisis and the argument that congressional acquiescence is indicative of legislative approval, it appears unlikely that private litigation under Rule 10b-5 or any other well-established implied cause of action is in danger of judicial abrogation. Elimination or restriction of existing implied causes of action by Congress is, of course, a possibility. See infra notes 374-98 and accompanying text.
150. Grundfest, supra note 7, at 978.
151. See id. at 976-80.
153. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976); see also United States v. O’Hagan, 92 F.3d 612, 627 (8th Cir. 1996) (holding that the SEC exceeded its rulemaking authority by enacting Rule 14e-3(a) to impose insider trading liability in the absence of a breach of fiduciary duty).
154. See Grundfest, supra note 7, at 979 & n.65 (citing cases).
had years of experience in applying the law of fraud to purchases and sales of a variety of assets. In many respects, it would appear that the only difference between deception covered by common-law fraud and deception covered by Rule 10b-5 is the type of asset involved in the purchase or sale.

A large body of jurisprudence has grown in this area over the last fifty years, as courts have issued opinions defining the federal common law of securities fraud. This body of federal common law includes not only decisions interpreting the scope of Rule 10b-5, but also decisions interpreting the parallel language contained in Rule 14a-9 dealing with misleading statements or omissions in connection with a proxy solicitation. Decisions interpreting the content of an element of the 14a-9 cause of action have often been considered persuasive by courts interpreting a parallel element of the 10b-5 cause of action, and vice versa. For the most part, Congress has acquiesced in the experiment of allowing federal courts to develop a federal common law of securities fraud.

The importation of common-law elements into a securities fraud cause of action has occasionally proven difficult. The common-law action for deceit, as it exists in most states, has five elements: (1) the plaintiff must have justifiably relied; (2) to her detriment; (3) on a misrepresentation of material fact; (4) made with scienter by the defendant (either with knowledge as to its falsity or with recklessness as to its falsity); and (5) made with the intention that the plaintiff rely on the fact misrepresented. The defects of the common-law action as a vehicle for combatting securities fraud have been succinctly argued:

First, there was often no affirmative misrepresentation; rather, the defendant omitted material information when dealing with the plaintiff. Thus the plaintiff was required to prove that the defendant had a duty to disclose the omitted material information prior to trading in order to satisfy the fraud requirement of a misrepresentation. A second problem arose from the reliance requirement. Even when a plaintiff could establish a duty to


157. See Cunningham, supra note 42, at 1415-16 n.18; see also United States v. O'Hagan, 92 F.3d 612, 625 (reading "fraudulent" under § 14(e) of the Securities Exchange Act to be coextensive with the meaning of fraud under § 10(b)), cert. granted, 117 S. Ct. 759 (1997). However, this is not always the case. See Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 777-78 (3d Cir. 1976).

158. See Solomon et al., supra note 30, at 920.
disclose, it was difficult to prove that [s]he had relied on the omitted fact. Moreover, the reliance requirement limited actions to those where the plaintiff and defendant had dealt directly; a plaintiff could not establish reliance when the transaction occurred through the impersonal medium of a securities exchange.\(^{159}\)

Therefore, the federal courts were quickly asked to modify the harsh effects on the plaintiff’s case if the common-law fraud action was to be used to define the contours of liability for the implied private right of action for securities fraud.\(^{160}\) Originally, federal courts were willing to comply with requests to relax the operation of common-law fraud elements in the securities context, due to the broad remedial purposes expressed by Congress when it enacted the Securities Exchange Act.\(^{161}\) Although common-law jurisprudence relating to fraud was imported into Section 10(b) in order to give content to an otherwise empty vessel, the interpretation given to the elements of the plaintiff’s claim was modified to reflect the unique environment surrounding securities transactions.

Six elements of a private cause of action for securities fraud are now commonly accepted. Having established standing, the plaintiff in a private 10b-5 action must establish: (1) in connection with the purchase or sale of a security; (2) a material misstatement or omission of fact; (3) made with scienter; (4) upon which plaintiff relied; (5) that caused; (6) injury.\(^{162}\) It is instructive to examine how the Supreme Court has defined the second, fourth, and fifth elements over the past decades.

### a. Material Misstatement or Omission of Fact

For purposes of a private action under Section 10(b), a misstatement or omission of fact is material when there is a “substantial likelihood” that a reasonable investor would consider it important in making her investment decision or, put differently, where there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”\(^{163}\) In *Basic Inc. v. Levinson*,\(^{164}\) the Court explained that the role of the materiality

\(^{159}\) *Id.; see also* Basic Inc. v. Levinson, 485 U.S. 224, 243-44 (1988).

\(^{160}\) See Johnson, *supra* note 155, at 709-10.


\(^{162}\) But see Cunningham, *supra* note 42, at 1415 (listing elements as (1) deception, (2) in connection with the purchase or sale of a security, (3) with scienter, (4) by one having a duty to disclose, (5) with respect to material facts) (citing *Basic*, 485 U.S. at 231).


\(^{164}\) 485 U.S. 224.
requirement is to “filter out essentially useless information,” thus setting an arguably low threshold for satisfaction of the element. However, of even greater significance from the perspective of the Rule 10b-5 plaintiff, is that the materiality standard applied by the Court is exceedingly fact-specific and, therefore, peculiarly appropriate for application by the trier of fact. Under the definition of materiality adopted, it is difficult for a defendant to negate the element as a matter of law on a motion for summary judgment.

The Supreme Court’s latest attempt to interpret the material misstatement or omission element occurred in a case arising under the federal proxy rules. In Virginia Bankshares, Inc. v. Sandberg, the Supreme Court held that a corporate board’s statement of its reasons for approving a merger plan constituted a misstatement of material fact that could give rise to private liability under Rule 14a-9. The Court first stated that there was “no serious question” that such a statement by the board may be materially significant. The Court then turned to the question of whether the board’s statement could properly be considered a statement of fact. Justice Scalia argued in dicta that the statement of the board’s subjective reasons for acting would not have constituted a factual statement if it had been preceded by the phrase “in their estimation.” However, the rationale of the opinion would not seem to make the determination of whether a statement was factual in nature turn upon whether the misstatement was explicitly identified as a statement of opinion. Instead, the holding provides that a material misstatement of fact may be present where there is a false statement of subjective belief—a statement inherently incapable of independent verification—but only in circumstances where (1) the belief or motives stated are not in fact subjectively held by the speaker, and (2) the statement itself has no reasonable basis in fact. Disbelief or undisclosed motivation alone cannot constitute a material misstatement of fact for purposes of a private action.

The treatment of the material misstatement or omission prong in Virginia Bankshares evidences an expansive view of the element. The

165. Id. at 234. But see id. at 231 (stating that the TSC Industries Court was “careful not to set too low a standard of materiality”).
166. See id. at 236, 240.
167. Recently, lower federal courts have seized upon the “bespeaks caution” doctrine as a way to reassert the court’s role in determining materiality as a matter of law, at least in the context of forward-looking information. See, e.g., In re Donald J. Trump Casino Sec. Litig.—Taj Mahal Litig., 7 F.3d 357 (3d Cir. 1993).
169. See id. at 1098.
170. See id. at 1090.
171. See id. at 1091.
172. Id. at 1090.
173. Id. at 1091.
174. See id. at 1096.
problem presented to the Supreme Court was whether statements of opinion, motivation, or subjective belief could give rise to a private action if the statements were not an accurate reflection of the speaker's true state of mind. A restrictive view of the element might confine the limits of materiality to objectively verifiable facts, and exclude any statement expressing the state of mind of the speaker.\textsuperscript{175} The rationale in support of such a view would be that the audience to which the statement is addressed knows full well that subjective opinions, motivations, and beliefs constitute the speaker's personal reaction to objective information and, as such, are but one possible interpretation of the available facts. Justice Scalia appears to be hinting at just such an approach.

By allowing an action to be maintained on the basis of a misstatement of the speaker's state of mind, albeit with some practical limitations imposed due to the inherent problems of proof that arise in this context, the majority is recognizing the importance that statements of opinion can play in the context of the total mix of information available to the audience. The importance of such statements may be magnified in the securities context when the opinions, motivations, or beliefs expressed are held by insiders with access to more information than the audience. Therefore, the Court's treatment of the element is consistent with the relaxation of the requirements of common-law fraud, with a view toward minimizing the likely problems of proof engendered by the Court's interpretation.\textsuperscript{176} The Court's reasoning relies heavily on the policy analysis contained in \textit{Blue Chip Stamps} as it seeks to define the material misstatement or omission element in light of "what is and is not manageable in the litigation of facts."\textsuperscript{177}

b. Reliance

At common law, the plaintiff in a fraud action is typically required to demonstrate the element of reliance.\textsuperscript{178} This requirement can be satisfied by a showing that the plaintiff either acted or failed to act as a result of the defendant's misstatement. A necessary prerequisite for the existence of reliance at the common law is the plaintiff's actual knowledge of the misstatement.\textsuperscript{179} However, in the context of

\textsuperscript{175} Justice Scalia noted that, at common law, no action for misrepresentation lies for misstatements of belief. \textit{See id.} at 1110 (Scalia, J., concurring) (citing \textsc{W. Page Keeton Et Al., Prosser And Keeton On The Law Of Torts} § 109, at 760-62 (5th ed. 1984)); \textit{see also} \textsc{Hazen, supra} note 71, at 801.

\textsuperscript{176} \textit{But see} Cunningham, \textit{supra} note 42, at 1443-44 & n.145 (reading \textit{Virginia Bankshares} as a case addressing the element of scienter and concluding that the Court effectively heightened the burden of proof placed on plaintiffs).

\textsuperscript{177} 501 U.S. at 1091.

\textsuperscript{178} \textit{See, e.g.,} Mirkin v. Wasserman, 858 P.2d 568, 572 (Cal. 1993); \textit{see also} \textsc{Keeton Et Al., supra} note 175, § 105, at 728.

\textsuperscript{179} \textit{See Basic Inc. v. Levinson}, 485 U.S. 224, 244 n.21 (1988) (quoting \textsc{Keeton Et Al., supra} note 175, § 105, at 726).
a securities transaction, the defendant’s omission of material facts can be as misleading as an affirmative misstatement. The Supreme Court recognized the practical difficulty that a plaintiff would have in proving reliance on omitted facts and, in *Affiliated Ute Citizens v. United States*, held that the 10b-5 plaintiff is entitled to a rebuttable presumption of reliance in an omission case involving a face-to-face transaction.

The reliance element was further relaxed in *Basic*, where the presumption of reliance was extended to plaintiffs who were not engaged in a face-to-face transaction with the defendant, so long as the securities transaction occurred on an efficient market. The “fraud on the market” theory of liability allows a purchaser or seller of stock at a distorted price to satisfy the element of reliance even where he or she has no knowledge of the misstatement causing the distortion. The Court justified this expansion of 10b-5 liability beyond the common law by pointing out that granting the presumption would promote the accurate disclosure of information in accord with Congress’s purposes in passing the securities laws, would avoid the problems of proof in omission cases described in *Affiliated Ute Citizens*, and would be consistent with empirical data supporting the hypothesis that security prices on an efficient market accurately reflect all public information, including material misstatements.

c. Causation

In many ways, the Supreme Court’s interpretation of the causation element provides the underpinnings for both the embrace and

181. See id. at 153-54.
182. See *Basic*, 485 U.S. at 227.
183. See id. at 241-42.
184. See id. at 245-46 (noting that “Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor’s reliance on the integrity of those markets”). The rule adopted by the Court may also over-deter the making of inaccurate disclosures. The liability that the rule creates for the person or entity that misspeaks—a liability that extends not just to those investors who had knowledge of the misstatement, but to all purchasers or sellers of stock at the time—can be out of proportion with the severity of the misstatement.
185. See *Basic*, 485 U.S. at 245.
eventual rejection of the methods employed to define reliance. The element of causation incorporates both transaction causation (traditional "but for" causation) and loss causation (the requirement of a causal link between the fraud and the claimed economic loss).  

187 In *Mills v. Electric Auto-Lite Co.*, 188 the Supreme Court reasoned that the plaintiff in a 14a-9 action should receive a presumption of causation where the plaintiff demonstrated a material misstatement or omission in a proxy statement and where the proxy solicitation in general was an essential link in the accomplishment of the challenged transaction. 189 The Court reasoned that, having established the existence of a material misstatement or omission, it was appropriate to relieve the plaintiff of the difficult burden of proving the fact that the fraud was the determinative factor in the outcome of the shareholder vote. 190

In *Virginia Bankshares*, the Supreme Court was confronted with the question of whether to extend the *Mills* presumption to circumstances where the majority vote of the shareholders had not been necessary in order to accomplish the challenged transaction. 191 The Court refused to do so, holding that the requirement that the plaintiff prove a loss caused by the defendant's fraud precluded it from presuming causation in circumstances where the proxy solicitation itself was not essential. 192 If a majority vote of the shareholders was not necessary in order for the defendants to accomplish their goals, then the fraud could just have easily occurred in the absence of a misstatement in the proxy solicitation. Under such a scenario, the misstatement can hardly be said to have caused plaintiff's injury.

Justice Kennedy's dissent in *Virginia Bankshares* points out that the majority's holding departs from the approach that the Court had originally adopted in *Mills*. 193 Justice Kennedy argued that, in light of the existence of a falsehood in the proxy statement, the Court's prior interpretation of the elements of a 14a-9 action would support the relaxation of the causation requirement in this instance. 194 He noted that *Mills* had relaxed the causation requirement for plaintiffs based upon the impracticality of proving reliance by thousands of shareholders in circumstances where it was nonetheless likely that the proxy violation had contributed to the plaintiffs' damages. 195 He concluded


189. *Id.* at 384-85. In other words, so long as a majority vote of shareholders is necessary to accomplish the transaction complained of, the Court will presume that the misstatement or omission caused the majority to vote as they did.

190. *See id.* at 385.


192. *See id.* at 1102.

193. *See id.* at 1114 (Kennedy, J., dissenting).

194. *See id.* at 1118.

195. *See id.* at 1116-17.
that the fact that only a minority of the shareholders were deceived in *Virginia Bankshares* did not necessarily reduce the likelihood that the solicitation of proxies was a causal factor in their injury.\(^{196}\) Therefore, extension of the presumption of causation under these facts would be consistent with *Mills*. In his own dissenting opinion, Justice Stevens suggested that granting a presumption of causation even where the proxy solicitation was not essential would deter future misstatements, thereby preserving the shareholders' ability to cast a meaningful vote and furthering Congress's purpose in passing Section 14 of the Securities Exchange Act.\(^{197}\)

The majority's adherence to a strict causation requirement in *Virginia Bankshares* appears to be a conscious policy choice designed to prevent causes of action, such as Rule 14a-9 in this case, from becoming insurance policies for investors. Further relaxation of the causation requirement raises the prospect that shareholders, disappointed with the outcome of a transaction approved via proxy solicitation, could scour the solicitation materials for misstatements after the fact without regard to whether such misstatements had actually led to the shareholders' economic loss. In making this choice, the Court in *Virginia Bankshares* signaled that it would no longer use policy rationales to extend the already expansive definition of certain elements of the implied causes of action under the securities laws.\(^{198}\)

d. The Relaxation of Common-Law Fraud Elements

Although it is difficult to find a consistent pattern in the Court's approach to defining the elements relevant to a 10b-5 action, one recurring theme has been the occasional judicial relaxation of elements drawn from the common law of fraud. Where it has done so, the Supreme Court has reallocated the burden of proof between the plaintiff and defendant based on its own assessment of "fairness, public policy, ... probability, ... [and] judicial economy."\(^{199}\) Thus, the plaintiff was granted the presumption of reliance in omission cases.\(^{200}\) Under the "fraud on the market" theory, reliance was also presumed when the plaintiff purchased the security on the basis of the market price, under circumstances where the security trades on an efficient market, and where a misrepresentation or omission adversely affected the market price.\(^{201}\) Although the Court has also interpreted certain elements of the cause of action in a restrictive manner, the cumulative effect of decisions relaxing the traditional fraud elements made it difficult for defendants to win summary judgment in securities fraud cases.

\(^{196}\) See *id.* at 1117-21.
\(^{197}\) See *id.* at 1112 (Stevens, J., dissenting).
\(^{198}\) See *id.* at 1104-07.
\(^{201}\) *Basic*, 485 U.S. at 241-42.
The expense and uncertainty attendant with a trial on the merits therefore created an incentive for defendants to settle prior to trial and gave the plaintiff a certain degree of leverage in settlement negotiations.

2. The "New Textualism" in Securities Law Jurisprudence

Following Virginia Bankshares, the Supreme Court began to demonstrate a disillusionment with public policy and judicial economy as the stated basis for decision making in cases involving the private cause of action. The trend began in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, in which the Court chose to abandon a long-settled practice of borrowing analogous state-law statutes of limitation. Instead, it fashioned a statute of limitations for Section 10(b) from the language contained in the express causes of action set forth in the Securities Exchange Act. The majority did so despite the misgivings of some members of the Court that the text-derived limitations period did not adequately further the remedial goal of the private cause of action. The Supreme Court continued to search for meaning in the statutory language, rather than through common-law principles modified by policy rationales, when it confirmed the existence of a right to contribution under Section 10(b) in Musick, Peeler & Garrett v. Employers Insurance of Wausau. Finally, the Supreme Court explicitly embraced textualism as a guide in interpreting Section 10(b) in the Central Bank of Denver case. "Textualism" is the name given to an approach to statutory construction that limits itself to the literal reading of the statute, unless the statutory text is facially ambiguous or a literal reading leads to a bizarre result. Other traditional aids to the interpretation of texts—"the historical condition . . . that gave rise to the statute, and the propositions of policy, morality, and experience that provide the social context of the statute or otherwise bear on its subject matter"—are banned from the inquiry.

The actual holding of the Central Bank of Denver case is that the absence of any reference to aiding and abetting liability in the text of Section 10(b) precludes private liability on the basis of such conduct. The holding represents the first time that the Supreme Court has relied on the plain language of Section 10(b) to this extent. Whereas prior cases have read the language contained in the text of

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203. See id. at 359.
204. See id. at 359-61.
205. See id. at 374 (Kennedy, J., dissenting).
206. 508 U.S. 286, 288 (1993); see id. at 301-02 (Thomas, J., dissenting).
208. See id. at 13.
209. Id.
Section 10(b) restrictively, such as Chiarella’s holding that the use of the word “deceptive” limited the scope of prohibited conduct, Central Bank of Denver relies upon the absence of express language in the Section to narrow the scope of conduct covered by the text.

The above cases illustrate quite graphically that the Supreme Court’s securities jurisprudence has embarked on a new course. As Professor Eisenberg has pointed out, the majority in Central Bank of Denver could have chosen to write an opinion that abolished aiding and abetting liability in private actions on the basis of policy rationales such as the tendency of secondary liability under the securities laws to encourage vexatious litigation. Instead, the majority rejected this opportunity and made it clear that policy considerations would henceforth play little role in the interpretation of Section 10(b). The Court implemented its change in direction without overruling or explicitly criticizing that segment of precedent defining the boundaries of the cause of action in policy terms. In fact, in Central Bank of Denver, the Court claimed to find authority for its new course by citing to the very body of precedent that the majority rejected in favor of a completely different methodology.

The result of this shift in securities law jurisprudence is that a preexisting body of precedent under Rule 10b-5 must coexist with future decisions premised on the new textualism. The coexistence of two contradictory bodies of precedent will result in a schizophrenic map of the boundaries of securities fraud, where the factors determining the parameters of the cause of action are a hybrid of policy-oriented rationales and text-derived limitations.

IV. The Failure of Federal Common Law Under Rule 10b-5

A. The Vagaries of the Common Law

The combination of a standard of liability defined via a process of federal common law with an otherwise integrated and industry-specific statutory scheme has been a failure. The use of the federal common law to determine the scope of private liability under the securities laws has had two negative results. First, it has subjected the substantive scope of securities fraud liability to the vagaries of the common-law process. As a result, the cause of action has developed several internal inconsistencies. Second, it has allowed the substantive
standards of liability to evolve without appropriate fidelity to the overall structure of the securities laws as initially designed by Congress. Neither a policy-based nor a text-based interpretation of Section 10(b) has succeeded in fully integrating a judicially defined private cause of action for securities fraud into the overall system of securities regulation crafted by Congress.

It is possible that the existence of an express cause of action under Section 10(b) would not have foreclosed this same result. Even in the case of the most explicit congressional text, it can be argued that statutory interpretation by the judiciary is a "dynamic" process that rightly abandons original intent in order to update a statute in light of subsequent legal developments and contemporary legislative preferences. Dynamic statutory interpretation" is not a theory that seeks to explain how courts approach the task of statutory interpretation. Rather, it is a descriptive model that asks us to accept the fact that courts inevitably modify and develop statutory rights and obligations in response to a shifting social reality. The proponents of dynamic statutory interpretation might argue that the judicial power, however employed, would inevitably subject an express private cause of action under Section 10(b) to an equally unpredictable course.

However, dynamic statutory interpretation can be criticized as a model of judicial decision making on the grounds that it contravenes several fundamental principles underlying the appropriate role of the courts: (1) it is the prerogative of Congress to decide when changed circumstances merit the updating of a congressionally created right; (2) judges are incapable of accurately determining original legislative intent, and therefore any updating by the judiciary is inevitably a political act best left to Congress; (3) judicial attempts to update a congressionally created right risk the overenforcement of that right in areas best left to the common law; (4) continuity in legal obligations is preferable to change outside of the democratic process; and (5) the public has relied upon prior judicial interpretations in ordering its conduct.

Whether or not these principles weigh heavily enough to counsel in favor of judicial restraint in the interpretation of an express cause of action, they do provide persuasive grounds for resisting the use of federal common law to significantly reshape a judicially implied cause of action. In the absence of explicit congressional direction in the legislative language or history, the vagaries of federal common law do vio-

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217. See Eskridge, supra note 138, at 6.

218. See id. at 130-40. Professor Eskridge would argue that judicial innovations that do violence to these principles are unlikely if judges approach the problem of statutory interpretation in a pragmatic fashion. See id. at 109; Farber, supra note 216, at 1556-57; see also Calabresi, supra note 139, at 163-66.
lence to these principles in ways that differ, if not in kind, then in
degree from the usual process of statutory interpretation. If, as some
have argued, the concept of dynamic statutory interpretation in gen-
eral is "unjust,"\textsuperscript{219} then it is doubly so when the courts interpret an
implied cause of action in a dynamic fashion.

When Congress explicitly creates a cause of action, it implicitly
delegates a degree of authority to the judiciary to interpret the cause
of action in a manner designed to maintain the efficient operation of
the cause of action in the face of changing circumstances. However,
when an implied cause of action is found by the judiciary, it is fiction
to suggest that any conscious "delegation" of congressional authority
to update the cause of action has occurred. Nor can congressional
failure to overturn an implied cause of action, once its existence is
established, be deemed to constitute a delegation of authority to the
judiciary. Until Congress passes explicit statutory language setting
forth a cause of action, that body has not performed any deliberative
act from which one can derive a conscious desire to do anything.

In addition, courts engaged in the dynamic interpretation of an
implied right of action must do so with even less indicia of legislative
intent than a court interpreting an explicit cause of action. It is cer-
tainly true that courts are incapable of using statutory text or legisla-
tive history as infallible guideposts to discover original intent.
However, in the case of an explicit cause of action, these sources at
least provide the court with a map of the boundaries within which
original intent must lie.

Courts interpreting an implied cause of action do so on a map of
their own making. The less legislative guidance available to inform
the court's interpretation of a statute, the more the court is called
upon to perform a political function when it updates the law in re-
sponse to the exigencies of the present day.\textsuperscript{220} Statutory interpreta-
tion therefore can more easily devolve into judicial legislation that
unwisely expands the cause of action to the detriment of common-law
rules. For similar reasons, the judicial interpretation of an implied
cause of action is also more likely to frustrate the public's reliance
upon well-established legal doctrine. Lacking any evidence of legisla-
tive intent or purpose to cabin their discretion, judges may be unable
to resist abandoning a settled construction of the language giving rise
to the cause of action.

\textsuperscript{219} See D'Amato, supra note 138, at 935.

\textsuperscript{220} See also Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 367
(1991) (Stevens, J., dissenting) ("I believe . . . that Congress, rather than the Federal Judiciary,
has the responsibility for making the policy determinations that are required in rejecting a rule
selected under the doctrine of state borrowing, long applied in § 10(b) cases, and choosing a new
limitations period and its associated tolling rules.").
B. Duelling Policy Rationales in the Arena of Judge-Made Law

The use of federal common law to give content to the elements of a 10b-5 cause of action originally led the federal courts to rely heavily on policy arguments as a basis for constructing the cause of action. The language of Section 10(b) does not, by its own terms, prohibit anything, and there is no legislative history that explicates the appropriate scope of private liability. The Supreme Court has often stated that its task in construing the private cause of action is to infer what Congress would have done if it had considered the specific element at issue. 221 It is therefore inevitable that policy arguments play a critical definitional role in the securities fraud context because the vague language 222 utilized by Section 10(b) and Rule 10b-5, and the broad purpose of Congress 223 can be construed to support a host of alternative definitions of the elements of the plaintiff's case.

Individual court decisions interpreting the private cause of action have traditionally vacillated between a desire to promote two distinct policy goals. One goal is the overarching congressional purpose, in light of the conduct widely held to have contributed to the Stock Market Crash of 1929, to enact federal law that would protect investors and remedy similar abuses. 224 The second policy goal is one of judicial self-preservation: the need to prevent frivolous litigation that wastes judicial and social resources and that threatens the integrity of the court system. 225

Prior to the emergence of a text-based interpretation of Section 10(b), a touchstone that courts often utilized to choose between two alternative formulations of the private cause of action was the desire to effectuate the remedial purposes of the Securities Exchange Act. This policy rationale sometimes led federal courts to adopt expansive

222. See SEC v. Clark, 915 F.2d 439, 448 (9th Cir. 1990) (describing Rule 10b-5 as “notoriously vague”); Joseph A. Grundfest, We Must Never Forget That It Is an Inkblot We Are Expounding: Section 10(b) as a Rorschach Test, 29 Loy. L.A. L. Rev. 41, 41 (1995) (noting that the language of § 10(b) possesses “no intrinsic meaning but . . . must be plumbed for deeper consequence”).
223. In a well-known book, Judge Easterbrook and Professor Fischel argue that the assumed purpose of Congress, the protection of investors, is an illusory goal that need not be promoted by our securities laws. See Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 296-98 (1991). Their argument that many capital markets are efficient in the semistrong form leads them to reject the present structure of mandatory disclosure laws as a necessary means of achieving investor confidence in capital markets or as a necessary means of protecting unsophisticated investors. See id. at 303. See generally Cunningham, supra note 42, at 1449-51 (critiquing the argument of Easterbrook and Fischel). It need only be noted that the debate over the validity of the original purpose of the securities laws further undermines the utility of that purpose as the sole touchstone for determining the boundaries of securities fraud.
225. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740-41 (1975); see also Phillips & Miller, supra note 24, at 1023-27.

interpretations of the 10b-5 elements where such an interpretation was viewed as the alternative most likely to deter and punish fraud.226 However, the goal of adopting substantive rules designed to protect investors is a slippery one. An infinite set of legal rules could be justified as useful in furtherance of this goal. Indeed, prohibiting securities transactions altogether would undoubtedly prevent some investors from being defrauded. A broad goal such as the protection of investors is meaningless in the abstract.227

Instead, the federal goal of protecting securities investors must be viewed in the context of the legal protections available in the absence of federal regulation. It is reasonable to conclude that, at a minimum, Congress intended to use federal law as a vehicle to protect investors in circumstances where existing state law was inadequate.228 For many years, courts tasked with interpreting the implied private right of action under Section 10(b) have found that the overall goal of protecting investors could be advanced by the relaxation of previously existing state-law limitations on a fraud action.229

Congress was explicit that the securities laws were not intended to completely displace state law. There is no indication that, in passing Section 10(b), Congress intended to construct a vehicle for combatting fraud that had no relation whatsoever to the established contours of a common-law cause of action.230 Over time, however, the combination of lawmaking via a federal common-law process and fidelity to the broad goal of investor protection promoted an evolution of the 10b-5 cause of action, until certain elements became mere shadows of their common-law fraud counterparts. The erosion of the reliance requirement is a striking example. The “watering down” of state common-law limitations imported into the securities context eventually ceased, and judicial skepticism concerning the wisdom of relaxing the traditional elements of common-law fraud reached its height in the Virginia Bankshares case.231 By then, however, the damage was already done.

Plaintiffs, and the plaintiffs’ bar, rationally moved to take advantage of a federal cause of action that lacked the stringent standards

226. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (arguing that the language of § 10(b) and Rule 10b-5 should be read “not technically and restrictively, but flexibly to effectuate its remedial purposes”) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)).

227. Cf. ESKRIDGE, supra note 138, at 29 (“An attributed policy purpose is too general and malleable to yield interpretive closure in specific cases, for its own application depends on context and the interpreter’s perspective.”).


229. See supra notes 160-201 and accompanying text.


231. See supra notes 168-74 and accompanying text.
that state courts had used to prevent themselves from being overrun by fraud actions. Over time, the federal courts' adherence to a remedial policy rationale as an interpretive touchstone, on even an occasional basis, aggravated the already existing conditions that made the cause of action susceptible to the proliferation of nonmeritorious lawsuits. In this manner, interpretations of the cause of action intended to effectuate the broad remedial purposes of Congress had the cumulative effect of strengthening a dueling policy concern.

The federal courts have long attempted to give content to the securities fraud cause of action in light of the desire to prevent frivolous litigation from clogging the courts and intimidation of legitimate businesses. On many occasions, the Supreme Court has expressed concern over the special potential for vexatious litigation that exists under the federal securities laws.232 Sometimes, the Supreme Court recognized this potential even as it was adopting an expansive view of the statute due to countervailing policy concerns in favor of investor protection. In later years the Court demonstrated, on a more consistent basis, its willingness to act on the fear of vexatious litigation and adopt substantive legal rules intended to reduce securities fraud litigation in federal courts.233 In Virginia Bankshares, a case under Rule 14a-9, it seemed that the Court drew a line in the sand indicating its reluctance to further relax traditional common-law elements.234 The Court signaled that the desire to prevent vexatious litigation would henceforth trump Congress's broad goal of investor protection.

In more recent opinions interpreting Section 10(b), the Supreme Court has avoided an explicit weighing of these dueling policy rationales as the stated basis for its decision making. Overdependence on policy rationales might be perceived by observers as nothing more than legislation by the judiciary, which is reason enough for the rejection of this approach by certain current members of the Court. It also opens the Court to charges that its decisions are driven by the ideology of its members. In addition, an interpretive approach that relies upon two competing policy rationales cannot consistently promote either one.

Instead, the Supreme Court has chosen to redefine the previously accepted boundaries of the securities fraud cause of action on the basis of a textualist approach to the construction of the statute. The

232. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740-41 (1975); see also Johnson, supra note 34, at 439 n.114.

233. See Johnson, supra note 34, at 437-39 (citing to Supreme Court opinions which have served to reduce litigation in the areas of securities fraud, bankruptcy, and environmental regulation, and noting a similar trend in the Court's recent immigration law opinions).

234. See Virginia Bankshares Inc. v. Sandberg, 501 U.S. 1083, 1115 (1991) (Kennedy, J., dissenting) ("To the extent the Court's analysis considers the purposes underlying § 14(a), it does so with the avowed aim to limit the cause of action and with undue emphasis upon fears of 'speculative claims and procedural intractability.' . . . The result is a sort of guerilla warfare to restrict a well-established implied right of action.").
Supreme Court’s new textualism leads to a restrictive reading of the scope of conduct actionable under Section 10(b), one that carries the added benefit of reducing the volume of private securities fraud litigation in federal court. The practical effect of the Supreme Court’s interpretive shift has been to force the lower federal courts to retreat from imposing liability within boundaries that are defined by the distinct policy rationales discussed above. Actionable conduct, and the classes of defendants subject to liability, are now defined by the plain meaning of the text without reference to policy goals.

C. The Persistence of Ideology

1. Why Textualism as Employed Is Not Value Neutral

Notwithstanding the absence of any explicit reliance on policy arguments in its textualist approach, the adoption of this new method for interpreting Section 10(b) should not mask the fact that policy rationales continue to influence the manner in which textualism is employed in the securities fraud area. For example, the proponents of textualism concede that an interpretation limited to the plain meaning of the text need not be given effect where the result is “so bizarre” that Congress must have intended otherwise. It hardly bears noting that the determination that a particular statutory construction leads to a bizarre result is a uniquely subjective determination, and one that ultimately turns on the court’s view of the policies that Congress sought to promote.

It also appears that, rather than being a “value neutral” method of statutory interpretation, textualism as employed in the interpretation of Section 10(b) provides a vehicle to “cast in stone” the Court’s

235. See Eisenberg, supra note 207, at 13; Stephen Plass, The Illusion and Allure of Textualism, 40 VILL. L. REV. 93 (1995); see also United States v. O’Hagan, 92 F.3d 612, 622-27 (8th Cir. 1996) (adhering to plain language of Section 14(e) results in a restrictive interpretation of the conduct subject to SEC regulation under that provision), cert. granted, 117 S. Ct. 759 (1997).

236. See Grundfest, supra note 222, at 43.

237. See, e.g., Central Bank of Denver v. Interstate Bank of Denver, 511 U.S. 164, 188 (1994); see also Eisenberg, supra note 207, at 28 (calling the bizarre result exception “fundamentally inconsistent with the concept of strict textualism”).

238. See ESKRIDGE, supra note 138, at 45-46. In Gustafson v. Alloyd Co., 115 S. Ct. 1061 (1995), four members of the Court found nothing bizarre about the conclusion that liability for a misstatement in a prospectus under Section 12 of the Securities Act could extend to written communications in a secondary securities transaction. See id. at 1074 (Thomas, J., dissenting). Such an interpretation, based on the language of the text, would have significantly expanded the conduct subject to the 1933 Act without any evidence that Congress sought to reach secondary transactions with that legislation. See id. at 1068. This result also would have created an anomaly whereby oral misstatements were actionable under Section 12 only in the context of a primary transaction but written misstatements were actionable regardless of whether they occurred in a primary or secondary transaction. See also id. at 1068. Given the willingness of the minority in Gustafson to accept the above result as a logical requirement of the text’s language, one must question whether the proponents of a textualist interpretation of the securities laws will ever conclude that a textualist result is sufficiently bizarre to merit its avoidance. See id. at 1074 (Thomas, J., dissenting) (declining to explore the logical implications of a textualist reading of § 12(2), stating that “[o]ur job is simply to apply the [congressional] policy, not to question it”).
move toward a more restrictive reading of the statute. It makes unlikely any future reascendancy of an interpretation heavily influenced by the broad remedial purposes of the Securities Exchange Act. Textualism by itself, as a method of statutory interpretation, need not preordain either a restrictive or an expansionist result. Yet the very fact that it can be employed differently in different contexts raises the prospect that unspoken policy rationales are still driving the interpretive process. A skeptical observer might question whether the choice of textualism as an interpretive approach is merely a means to an end.

For example, the Supreme Court's own decisions in other areas of the law illustrate that textualism can sometimes result in an expansionist interpretation of statutory language. The Court's most recent textualist interpretations of the RICO statute, which have contributed to a string of decisions establishing an expansive scope of conduct actionable under that section, contrast sharply with the shrinking scope of the securities fraud cause of action under a similar textualist approach. In the RICO context, the Supreme Court appears reluctant to exclude any conduct from the ambit of "racketeering activity" in the absence of explicit direction in the statutory language. In the context of Section 10(b), the Court appears reluctant

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239. Cf. Eskridge, supra note 138, at 300-03 (arguing that a recognition of the limits of judicial resources has increasingly influenced the Rehnquist Court in its adoption of canons of statutory construction).

240. In support of its holding in Central Bank of Denver, the majority noted that the demise of aiding and abetting liability would diminish the potential for vexatious litigation and would decrease the fees charged to start-up companies by professionals who would otherwise be wary of secondary liability. 511 U.S. at 189. See generally Eskridge, supra note 138, at 44 ("[C]urrent values, including those widely shared as well as those more particular to the interpreter, will influence any interpreter's approach to the statutory text.")


243. See National Org. for Women, 510 U.S. at 257 ("Nowhere in either § 1962(c), or in the RICO definitions in § 1961, is there any indication that an economic motive is required."); Holmes, 503 U.S. at 279-80 (O'Connor, J., concurring) ("Although the words 'injury in [one's] business or property' and 'by reason of' are words of limitation, they do not categorically exclude nonpurchasers and nonsellers of securities from the universe of RICO plaintiffs."); see also United States v. Robertson, 115 S. Ct. 1732, 1733 (1995) (declining to read jurisdictional limit into statutory language); Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 495 (1985) ("If the defendant engages in a pattern of racketeering activity in a manner forbidden by [§ 1962's] provisions, and the racketeering activities injure the plaintiff in his business or property, the plaintiff has a claim under § 1964(c). There is no room in the statutory language for an additional ... requirement."); The Supreme Court, 1993 Term: Leading Cases, 108 Harv. L. Rev. 139, 359 (1994). But see Reves, 507 U.S. at 177-79. For an argument that the Central Bank of Denver case forebodes a shift to a similarly restrictive textualist approach to the RICO statute, see Taurie M. Zeitler, In Central Bank's Wake, RICO's Voice Resonates: Are Civil Aiding and Abetting Claims Still Tenable?, 29 Colum. J.L. & Soc. Probs. 551 (1996).
to include any conduct within the ambit of "a deceptive device or contrivance" absent an explicit order to do so in the statutory language.244

The words used to describe the prohibited conduct under the respective statutory sections—"deceptive device or contrivance" and "pattern of racketeering activity"—are each sufficiently broad and ambiguous to belie the argument that textualism alone accounts for the restrictive interpretation of the former and the expansive definition of the latter.245 Something more is at work. The merits of the textualist approach to statutory interpretation, its fidelity to congressional intent, and the concomitant avoidance of judicial "lawmaking" are undermined where the judiciary approaches the congressional language with a different predisposition under different circumstances.

The primary distinction between the Section 10(b) and RICO statutory sections is that the RICO private cause of action is an express creation of Congress, whereas the judiciary has implied the private cause of action for securities fraud.246 It is unclear, however, why this distinction, in and of itself, should influence an avowedly textualist approach to construing the statutory language. The premise of a textualist approach to statutory construction is a basic fidelity to the plain meaning of the statutory text as the primary, if not the only, evidence of legislative intent and purpose.247 It is not obvious that questions concerning the court's view of the "legitimacy" of the cause of action should play any role in a textualist reading of the statutory language.

The legitimacy or illegitimacy of an implied cause of action cannot be derived from the specific statutory provision at issue; if it could, the cause of action would be an express one. Instead, legitimacy or illegitimacy can be determined only in context. The legislative history of the Securities Exchange Act, including amendments in 1988248 and 1991249 that seem to accept the existence of an implied right of ac-


245. Cf. McNally v. United States, 483 U.S. 350 (1987). In construing the mail fraud statute, 18 U.S.C. § 1341, the McNally court stated: "Rather than construe the statute in a manner that leaves its outer boundaries ambiguous and involves the Federal Government in setting standards of disclosure and good government for local and state officials, we read § 1341 as limited in scope to the protection of property rights. If Congress desires to go further, it must speak more clearly than it has." Id. at 360; see also United States v. Brumley, 79 F.3d 1430, 1436-40, reh'd en banc granted, 91 F.3d 676 (5th Cir. 1996).

246. See Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 300 (1993) (Thomas, J., dissenting) (suggesting that prior interpretations of § 10(b) evidence a "restrained approach to implied remedies"); Holmes, 503 U.S. at 289 (Scalia, J., concurring) (justifying the distinction between the RICO and 10b-5 standing requirement on the basis that the latter is an implied cause of action).

247. See Eskridge, supra note 138, at 34.


tion, must be considered. The general practice and history of courts in implying remedies for violations of federal statutes at the time of Section 10(b)'s enactment is relevant to the question. The long-held position of the SEC, that private litigation is a necessary tool to enforce the overall congressional scheme, is an important factor. An individual judge's personal view as to the social benefits versus the social costs of private litigation also will weigh in the determination of legitimacy.

Considered in context, the question of the "legitimacy" of the implied cause of action under Section 10(b) has long been subject to debate. Any canon of construction seeking to justify a restrictive reading of Section 10(b) on the basis that—as an implied cause of action—it is somehow illegitimate must, of necessity, incorporate and rely upon the very objects of judicial subjectivity that textualism seeks to avoid. The meaning of the words employed by Congress are a constant; the variables are judicial attitudes concerning the circumstances under which a private cause of action should be implied to redress injury caused by a violation of the congressional language where such a cause of action is not explicitly created. In order to be true to its principles, a textualist interpretation of Section 10(b) should be employed without regard to questions concerning the legitimacy of the text. 

2. Textualism and the Legitimacy of the Cause of Action

The distinction between implied and express causes of action does appear to make a difference in the use of a textual approach to interpretation, if for no other reason than the ill favor with which implied private causes of action under federal law are currently viewed by the Supreme Court. Private litigation under Rule 10b-5 is but one of dozens of judicially created remedies for individuals injured by

250. See Grundfest, supra note 7, at 994-98 (criticizing the argument that these two statutory amendments constitute evidence of legislative acquiescence to the existence of a private right of action).

251. Cf. Gabaldon, supra note 123, at 178. In discussing the manner in which federal courts have answered questions concerning their own ability to "make law" in the absence of congressional authority, Professor Gabaldon concludes that "[i]deology... seems more promising than judicial precedent as a guide to the resolution selected by any decision-maker." Id.

252. Compare Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 300 (1993) (Thomas, J., dissenting) ("How a particular private cause of action may have emerged should not weaken our vigilance in the subsequent interpretation and application of that action. Our inquiries into statutory text, congressional intent, and legislative purpose remain intact.") with Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1110 (1991) (Scalia, J., dissenting) ("I think [the 14a-9] cause of action at issue here was never enacted by Congress... and hence the more narrow we make it (within the bounds of rationality) the more faithful we are to our task.").

253. See Plass, supra note 235, at 101 ("In practice, [textualism] is a malleable theory subject to variation and manipulation and can be applied with as much or as little consistency as a particular judge chooses."); cf. Gabaldon, supra note 123, at 196-97.
a violation of federal law. It is an example of the federal judiciary's response to the explosive growth of congressional legislation in the first half of this century: a judicial attitude that strived to find a remedy for every injury in violation of congressional policy. Under statutory tort theory, a defendant's violation of a statute is unreasonable conduct, and recovery will be had where the plaintiff is a member of the class the statute was intended to protect. The very first federal court to recognize the implied private right of action under Section 10(b) based its holding upon a statutory tort analysis. Although the Supreme Court has never directly addressed the issue of whether an implied private right of action is proper under Section 10(b), it has accepted the existence of the 10b-5 right of action as an unalterable part of the federal judicial landscape.

From the outset, the standards for creating an implied private right of action were unclear, even if the judicial power to do so had not yet come into question. The circumstances under which a private cause of action was to be implied by the federal judiciary were finally specified in *Cort v. Ash.* In subsequent years, the *Cort* test was sharply limited as the federal courts came to question whether judicially created remedies constituted judicial legislation in contravention of the courts' constitutional role. In addition, the courts increasingly began to doubt the wisdom of creating implied private rights of action as they grappled with crowded dockets, discovery wars, and the

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254. See, e.g., J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964). In Borak, the Supreme Court implied a private right of action for a violation of the federal proxy rules from Section 27 of the Securities Exchange Act of 1934, despite the argument that the language of Section 27 makes no specific reference to a private right of action. The Court rejected a textualist reading of the statute because, among other reasons, the availability of judicial relief was necessary to achieve Congress's broad remedial purpose (to protect investors) in regulating the solicitation of proxies. See id. at 434-35. Another policy rationale supporting the Court's decision in *Borak* was the need to supplement government enforcement of the proxy rules with the deterrent effect of private litigation. See id. at 432.

255. See *Restatement (Second) of Torts* § 286 (1965).


258. 422 U.S. 66 (1975). The *Cort* decision created a four-part test to determine whether federal courts should recognize an implied private right of action premised upon a violation of a federal statute. See id. at 78. The factors to be considered were: (1) whether the plaintiff was a part of the special class on whose behalf the statute was passed; (2) whether there was any evidence of legislative intent to create a private remedy; (3) whether the creation of a private right of action is consistent with the underlying legislative scheme; and (4) whether the asserted cause of action is one traditionally relegated to state law. See id.

other inevitable burdens visited upon the limited resources of the federal court system by an ever-expanding pool of federal remedies.

Today, newly implied private causes of action under federal law are a rare spectacle indeed.\textsuperscript{260} However, the private cause of action under Rule 10b-5, as well as certain other causes of action implied under federal law in the years prior to retrenchment, remain an established part of the legal landscape.\textsuperscript{261} They seem destined to survive eternally under principles of stare decisis and the theory that legislative acquiescence toward their existence constitutes approval of the implied private right.\textsuperscript{262}

Inevitably, an occasional dispute concerning the boundaries of these previously recognized implied private rights of action will reach the Supreme Court. In resolving such a dispute, the members of the current Court have no choice but to confront the body of judge-made law that serves as precedent. So long as the Court's holding leaves in place the implied private right of action, the Court cannot avoid the process of "making law," a process that must be embarrassing and distasteful to any self-proclaimed judicial conservative.\textsuperscript{263} These unwanted implied causes of action are like the bastard children of a Victorian gentleman: they reappear from time to time on the Supreme Court's doorstep to demand its attention and to call into question the legitimacy of the majority's conservative self-image.

\textbf{D. The Vagaries of the Common Law Lead to a Troublesome Destination}

Different policy arguments appeal to different judges, as evidenced by the changing judicial perspectives that have influenced the content of the Rule 10b-5 cause of action over time.\textsuperscript{264} Certain ele-


\textsuperscript{261} In addition to the implied private right of action under Section 10(b) and Rule 10b-5, courts have found the existence of an implied cause of action under the following sections of the 1934 Securities Exchange Act: § 13(e)(1), 15 U.S.C. § 78m(e)(1) (1994); § 14(a), 15 U.S.C. § 78n(a); and § 14(e), 15 U.S.C. § 78n(e). See generally Grundfest, supra note 7, at 964 n.3.

\textsuperscript{262} See Gabaldon, supra note 123, at 174-75.

\textsuperscript{263} See id. at 166 (observing that criticism of federal common law is founded on issues relating to separation of powers and federalism); see also Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 365-66 (1991) (Scalia, J., concurring) (joining in the adoption of a statute of limitations for § 10(b) actions based on the model of the express causes of action contained elsewhere in the statute, but noting dryly that \"[w]e are imagining here\")

\textsuperscript{264} Legal realists contend that the holding in any given case is inevitably influenced by the background and world view of the individual judge deciding the case. See William H. Page, \textit{Legal Realism and the Shaping of Modern Antitrust}, 44 EMORY L.J. 1 (1995). However, judges have greater discretion to self-select the governing policy rationales in the development of common-law rules than they possess in the interpretation of statutes, where the court must account
ments of the private cause of action have been defined expansively, in a manner benefitting potential plaintiffs, because judges at the time of these decisions accepted the policy argument that the deterrent purpose of the securities laws was best achieved by granting the protections of Rule 10b-5 to the largest class of investors possible. The cause of action has been interpreted more restrictively in recent years, benefitting potential defendants. The prevailing attitude among the Justices of the Supreme Court today appears to be that nonmeritorious strike suits must be avoided at all costs, even if some valid claims are lost due to a restrictive interpretation of the element. Precedent interpreting Rule 10b-5 can thus be viewed as a river, twisting and turning as it approaches the finality of a Supreme Court pronouncement on each element, and sometimes taking unexpected turns. This is what is meant by the expression "vagaries of federal common law."

The "ebb and flow" of Rule 10b-5 jurisprudence as it occurs in the lower courts has been accepted by many scholars. Professor Lawrence Cunningham described this process as follows:

Judicial innovations in Rule 10b-5 jurisprudence by the lower federal courts tend to respect existing parameters, although they refine the contours in significant ways. So long as those refinements respect and advance the purposes of the federal securities laws in doctrinally and theoretically defensible ways and in accordance with the principles developed by the Supreme Court, they are acceptable. Indeed, in many instances such judicial innovation has been a necessary and appropriate step in the 60 year evolution of Rule 10b-5. Criticism is warranted when for the particular policy values reflected in the statutory text. See Eisenberg, supra note 215, at 29.

266. See Stern, supra note 128, at 2.
267. See also Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1105-06 (1991) (concluding that risk of strike suits, protracted discovery, and self-serving testimony justifies the interpretation of § 14(a) so as to avoid speculative claims in general, even though the plaintiffs' claims in the instant case may have merit).
268. Professor Grundfest has characterized the judicial precedent in regards to Rule 10b-5 as follows: "Although a substantial body of judicial precedent supports the implied private right, that precedent is far from uniform, is not well-reasoned, and is rife with contradiction." Grundfest, supra note 7, at 985. Elsewhere it has been noted that "the jurisprudential history of the rule is one of fits and starts—romantic times of doctrinal invention and ad hoc subjectivity rhythmically giving way to a classical emphasis on predictability, notice, and order—in a way characteristic of the common law generally." Cox ET AL., supra note 184, at 719. See generally Donald C. Langevoort, Rule 10b-5 as an Adaptive Organism, 61 FORDHAM L. REV. S-7, S-15 (1993) ("The process of adaptation in the jurisprudence of Rule 10b-5 is constant; it is only the direction of this adaptation that is difficult to discern.").
269. See S. Scott Lutton, The Ebb and Flow of Section 10(b) Jurisprudence: An Analysis of Central Bank, 17 U. ARK. LITTLE ROCK L.J. 45, 47 (1994) (describing the antithetical relationship between strict Supreme Court constructions of § 10(b) and ameliorative interpretations that are still prevalent among the lower federal courts).
270. See Langevoort, supra note 103, at 867.
such innovation leads numerous courts to articulate the applicable standards in a radically new way that fails to respect or advance the purpose of the rules in defensible ways or in accordance with Supreme Court precedent.271

By this standard, the recent innovations of the Supreme Court itself warrant criticism. The Supreme Court’s doctrinal change of course in embracing a textualist reading of Section 10(b) goes beyond a lower court’s refinement of the undeveloped “contours” of the cause of action, and instead constitutes a substitution of new principles for the previous tenets used to guide judicial decision making in the area. Of course, the Supreme Court need not treat its own precedent with the same deference expected from the lower federal courts. It also may be unsurprising that the interpretation of a federal statute should change over time.272

However, the absence of any meaningful text or legislative history to cabin its discretion gives the Supreme Court the ability to make more radical innovations in the interpretation of Section 10(b) than is possible in the typical exercise of statutory interpretation. The freedom inherent in declaring principles of federal common law, rightly viewed with suspicion in Erie Railroad Co. v. Tompkins,273 can easily lead to abuse. At first glance, the move toward a textualist interpretation of Section 10(b) appears to be an attempt to sever all ties with the methodologies that have allowed prior precedent to develop with such twists and turns. However, the move toward textualism is, itself, a new twist resulting from changed judicial attitudes. By shifting to a textualist approach, the Supreme Court is contributing to the vagaries of the federal common law of securities fraud and, unfortunately, directing us toward a particularly troublesome destination.274

The abandonment of a well-developed body of precedent creates uncertainty as to the legal rules that will govern future conduct.275 The financial services industry, in particular, is an industry in which it is vital for the market participants to know their potential legal liability at the outset, in order to gauge potential risk and expected costs.276

271. Cunningham, supra note 42, at 1413 n.8.

272. See Eskridge, supra note 138, at 11 (“Over time, the interpreter’s perspective diverges from that of the statute as a result of changed circumstances which give rise to unanticipated problems, developments in law and the statute's evolution, and different political and ideological frameworks.”). 273. 304 U.S. 64 (1938) (abolishing the concept of a general federal common law).

274. See also Eisenberg, supra note 215, at 74 (“A legal rule whose [common-law] development follows a jagged path tends to be highly unstable.”).

275. The doctrine of stare decisis ameliorates these weaknesses of the common-law process. As noted by Justice Stevens in his Central Bank of Denver dissent, the “settled construction of an important federal statute should not be disturbed unless and until Congress so decides.” Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 196 (1994) (Stevens, J., dissenting) (quoting Reves v. Ernst & Young, 494 U.S. 56, 74 (1990)).

276. See Central Bank of Denver, 511 U.S. at 188 (explaining that regulation of securities practices is “an area that demands certainty and predictability” (quoting Pinter v. Dahl, 486...
Sanctions for fraud serve a purpose only when they influence the behavior of market participants. If potential liability is unpredictable, then there is no incentive to modify behavior. As federal common law developed by the judiciary, securities fraud jurisprudence lacks the predictability and precision of federal law embodied in a statute.

Beyond the uncertainty inherent in federal common law, the definition of the implied private cause of action via an evolving process of statutory construction is a poor method to "ensure that the rules established to govern the 10b-5 action are symmetrical and consistent with the overall structure of the Act." In general, systemic consistency within a body of law helps to ensure that legal rules are predictable, evenhanded, and defensibly rational. Construing the Section 10(b) cause of action as part of an integrated scheme of federal securities regulation is important for several reasons. Such a construction helps to ensure that the implied action does not conflict with the express rights of action created by Congress, and it promotes "clarity, consistency and coherence for those who rely upon or are subject to 10b-5 liability." Too often, the shifting course of securities fraud jurisprudence has neglected this value. Individual judges and courts have construed Section 10(b) by embracing policy rationales or interpretive models that, although not without merit in isolation, nonethe-


277. See Central Bank of Denver, 511 U.S. at 188-90; S. REP. No. 73-792, at 6 (1934) ("[E]ffective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.").

278. See Dirks, 463 U.S. at 658 n.17.

279. See M. Stuart Madden, The Vital Common Law: Its Role in a Statutory Age, 18 U. ARK. LITTLE ROCK L.J. 555, 567-72 (1996) (discussing shortcomings of common-law process). One foundational value that the common law should strive for is replicability. Lawyers who advise private actors in areas subject to common-law rules must be able to replicate the process of judicial reasoning in order to describe the current state of the law. "[I]f courts [do] not use a replicable process of reasoning the profession [cannot] give reliable legal advice in planning and dispute-settlement, and planning and dispute-settlement on the basis of law would be frustrated." Eisenberg, supra note 215, at 11.

Similarly, Judge Easterbrook and Professor Fischel have argued that federal antifraud rules are a necessary complement to state law because the legal error engendered by the "calculated ambiguity" of the common law creates risk and litigation costs that are borne by participants in securities transactions. Easterbrook & Fischel, supra note 223, at 302. Of course, the increased efficiency of federal law depends on that law being more predictable and less ambiguous than the common law it would supplant.

280. Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 294 (1993); see also id. at 305 (Thomas, J., dissenting) ("The rule adopted today thus undermines not only the discernable intent of Congress and the SEC, but also our own elaboration of this regulatory scheme. Such are the risks that inhere in the 'hazardous enterprise' of recognizing a private right of action despite congressional silence.").

281. See Eisenberg, supra note 215, at 44.

282. Musick, Peeler & Garrett, 508 U.S. at 295.
less bear no relation to the overall structure of the Securities Exchange Act.\textsuperscript{283}

The vagaries of the federal common law of securities fraud also undermine the authority of the judiciary. It is inevitable that law derived from the interpretation of statutes will evolve and incorporate the assumptions of the judges who make such law. Untethered from guiding principles set forth by the legislature, however, this evolution may be unduly influenced by subjective factors. Professor Grundfest has noted that

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\text{[t]he lack of a "discernible pattern" in the resolution of securities fraud suits is harmful not just because of an "anti-plaintiff" or "anti-defendant" tilt that may be reflected in the outcome of individual cases, but because of the cynicism toward the law that inevitably results from a regime in which the identity of the judge or the venue of the proceeding can be more important than the facts underlying the dispute.}\textsuperscript{284}
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Although the same cynicism may result from the judicial interpretation of a more explicit statute, the potential is markedly increased when the judge, alone, is perceived to define the parameters of the parties' legal rights.\textsuperscript{285}

In other respects, the vagaries of the federal common law of securities fraud reveal how the content of the private cause of action is vulnerable to changing trends in judicial philosophy.\textsuperscript{286} It is not surprising that, over time, differing views concerning the appropriate role of judges as lawmakers come to predominate among the judiciary. For example, an interpretative method such as textualism—divorced as it is from legislative history and public policy—has a surface appeal for judges who place a high value on the separation of powers between the legislative and the judicial branches and who favor judicial restraint. However, it is unclear why the current popularity of textualism among some segments of the judiciary should determine when specific conduct should or should not be deemed fraudulent.

The irony of the turn toward textualism in the securities law context is that, in application, it can ignore the will of Congress and therefore undermine the very separation of powers that textualism is

\begin{footnotes}
\textsuperscript{283} See supra notes 129-39 and accompanying text.
\textsuperscript{284} Grundfest, supra note 14, at 739.
\textsuperscript{285} See Eisenberg, supra note 215, at 10 (stating that, when courts abandon existing common-law standards in favor of a substantially different standard, this event threatens the legitimacy of legal rules crafted by "an institution that is not conceived as representative, has a narrow base of experience, and is deliberately structured in a fashion that limits its accountability and responsiveness to the citizenry as a whole").
\textsuperscript{286} For examples of how judicial decision making may be viewed as the product of a "judicial philosophy" comprised of basic assumptions and methods of reasoning, see Fallone, supra note 34, at 860-61; Edward A. Fallone, Neither Liberal nor Laissez Faire: A Prediction of Justice Ginsburg's Approach to Business Law Issues, 1993 Colum. Bus. L. Rev. 279; see also Plass, supra note 235, at 129-31.
\end{footnotes}
intended to respect. An example of such a result occurred in the aftermath of the *Central Bank of Denver* opinion. When the Supreme Court eliminated aiding and abetting liability in private litigation in *Central Bank of Denver* on the basis of the statutory language, its reasoning also eliminated aiding and abetting liability in civil and criminal actions brought by the SEC against aiders and abettors. It is doubtful whether the Congress of 1934 intended such a limitation on the Commission’s enforcement authority. The Private Securities Litigation Reform Act of 1995 overturned the *Central Bank of Denver* opinion insofar as it applied to actions brought by the SEC.\(^{287}\) Prior to the advent of the textualist approach, the scope of the implied private cause of action could be judicially developed and refined without fear of infringing upon the statute’s express grant of enforcement authority to the Commission.

By leading to the embrace of textualism, the vagaries of the federal common law of securities fraud have also created an internal inconsistency within the private cause of action. Because the *Central Bank of Denver* majority disavowed any intention to overrule prior precedent,\(^{288}\) the textualist approach to interpreting Section 10(b) will be utilized only in the resolution of certain issues as yet unsettled in relation to the scope of liability, such as whether secondary liability may be imposed using common-law doctrines of respondeat superior. Textualism does not “undo” the settled expansive interpretation of certain elements of the cause of action, such as reliance.\(^{289}\)

It serves no purpose to have some aspects of private liability constrained by the language of the text when the elements of the cause of action have developed free from such constraints, particularly when the distinction between questions relating to the scope of liability and questions relating to an element of the plaintiff’s claim is a fine one.\(^{290}\) The elements of the plaintiff’s cause of action should be defined in relation to, and interdependently of, one another. Of particular concern, however, would be the adoption of a textualist interpretation of the scope of liability that subverts the scope of elements that have heretofore been defined in policy terms.

For example, the implications of *Central Bank of Denver* for respondeat superior liability are obvious: the analysis contained in the majority opinion would preclude secondary liability premised on respondeat superior principles for the simple reason that the statutory

\(^{287}\) See Securities Exchange Act § 20(f); see also Roman, *supra* note 34, at manuscript page 78.


\(^{289}\) See *supra* notes 178-86 and accompanying text.

\(^{290}\) Cf. *Central Bank of Denver*, 511 U.S. at 195-96 (Stevens, J., dissenting) (“There is a risk of anachronistic error in applying our current approach to implied causes of action . . . . to a statute enacted when courts commonly read statutes of this kind broadly to accord with their remedial purposes . . . .”).
text contains no mention of such liability. One might observe that the only liability contemplated for non-knowing participants in fraudulent conduct, such as employers, is under the provisions of Section 20(a) of the Securities Exchange Act relating to "control persons." Congress's express inclusion of this section in the Securities Exchange Act adds weight to the argument that the exclusion of general respondeat superior liability within the language of Section 10(b) was intentional.

However, such a textual analysis may have implications for the as yet unsettled interpretation of the scienter element. The Central Bank of Denver majority holds out the prospect that an element of the plaintiff's claim, such as the scienter requirement, may still be defined with reference to overall policy considerations. When considering whether recklessness is sufficient to satisfy the scienter element, however, a lower court would have to give some weight to a Supreme Court decision holding that a wide variety of non-knowing conduct by employers and the like is not actionable. The existence of such a holding immediately puts the plaintiff on the defensive: instead of arguing why public policy supports the imposition of liability for reckless conduct, the plaintiff must argue why public policy requires treating primary actors differently than secondary actors. Although this may not be an insurmountable hurdle, it is conceivable that the textualist approach as applied to a question dealing with the scope of liability, however defined, may end up constricting or otherwise subverting the ability of later litigants to argue for expansive interpretations of the elements of the cause of action.

Finally, the vagaries of the federal common law have led us to a dead end. Textualism may ultimately prove incapable of practical application in the context of Section 10(b). The language of that Section and of Rule 10b-5 is too vague to provide much guidance in isolation from policy considerations. Requiring support in the text itself before liability can be imposed on the basis of challenged conduct is problematic given the fact that the statutory language is a hollow shell. The text is so vague that it has been characterized as a Rorschach test: the reader can give meaning to the language of the text only by bringing to bear his or her own understanding of the policy goals served by the securities laws. In the end, textualism is a formalistic device that masks the continued persistence of policy-based rationales as the

293. See Grundfest, supra note 222, at 43; see also D'Amato, supra note 138, at 935 ("Hasn't justice become impossible to get from courts if judges insist on upsetting both sides' expectations of what law was when their case or controversy arose, and instead pull the rug out from under their feet with new law based on the judges' own idea of general social and governmental policy? . . . Isn't this the very definition of injustice?").
source of content for the cause of action.\textsuperscript{294} The Justices will continue to adopt and reject different motivational grounds for their interpretations of Section 10(b), but the true reasons for these twists and turns will be hidden behind a screen of textualism.

V. CODIFICATION UNDER A STRUCTURALIST APPROACH

A. The Merits of a Structuralist Interpretation

1. Structuralism Versus Textualism

A basic flaw in the interpretation of Section 10(b) under existing Supreme Court jurisprudence is that the boundaries of the private cause of action have been defined with insufficient attention to the overall statutory scheme of the 1933 Securities Act and the 1934 Securities Exchange Act. The importation of common-law principles in order to give Section 10(b) substance, as modified on the basis of policy rationales, does not speak to the overall structure of federal regulation.\textsuperscript{295} Recognition of this deficiency in the common-law approach appears to have inspired the majority to shift gears in Central Bank of Denver.\textsuperscript{296} However, the Court's embrace of a textualist approach shares the same deficiency as the prior common-law approach. Both methods of interpreting Section 10(b) subordinate the underlying congressional principles revealed in the structure of the securities laws to other interpretive guides, whether they be public policy or isolated textual provisions.

Theories of statutory interpretation are typically divided into three inquiries concerning: (1) the intent of the legislature ("intentionalism"); (2) the purpose of the statute ("modified intentionalism"); or (3) the plain meaning of the text itself ("textualism").\textsuperscript{297} It is fruitless to argue for a return to the original intent of the 1934 Congress in defining the scope of a 10b-5 action, because that body never intended to create a private right of action in the first place.\textsuperscript{298} In regards to the other two alternatives, the Supreme Court has struggled with the selection of an appropriate interpretive method in the context of Section 10(b).

\textsuperscript{294} See Farber, supra note 216, at 1549. A lack of candor in failing to disclose the true reasoning employed in their written opinions raises the prospect that judges—who are discharging a public function—will not be held accountable for their actions. See Idleman, supra note 139, at 1335-45.


\textsuperscript{296} See 511 U.S. 164, 178-80 (1994) (refusing to imply aiding and abetting liability under § 10(b) due, in part, to the lack of aiding and abetting liability under the express causes of action contained within the securities laws).

\textsuperscript{297} See William N. Eskridge, Jr. & Phillip P. Frickey, Statutory Interpretation as Practical Reasoning, 42 Stan. L. Rev. 321 (1990); see also Eskridge, supra note 138, at 14, 25, 34 (ascribing the name "purposivism" to modified intentionalism).

\textsuperscript{298} See Thel, supra note 144, at 385.
The courts originally attempted to apply a form of modified intentionality to Section 10(b). As discussed above, the broad purpose of Section 10(b) minimizes the utility of this approach and necessitates the use of policy rationales as an interpretive aid in order to give content to the private cause of action. At times, principles of public policy have informed the interpretation of Section 10(b) without any reference to the principles underlying the carefully designed structure of the securities laws.

This point was made tellingly by the dissent in *Dirks v. SEC.*299 The *Dirks* case dealt with the standard under which a tippee could be prosecuted for insider trading. Justice Blackmun’s dissent points out that the majority, by holding that a tippee could violate Section 10(b) only in circumstances where the tipper received a pecuniary gain for his actions, adopted a limitation on the scope of Section 10(b) that ignored the question of whether the challenged conduct caused an injury that the Securities Exchange Act was intended to prevent.300 There may have been compelling policy reasons for requiring a pecuniary gain on the part of the tipper in order to impose liability, but those reasons lack any obvious connection to the reasons Congress sought to regulate market conduct via the Securities Exchange Act.301

The elements of a common-law fraud action were developed to reflect interpersonal transactions where one party was directly deceived by the word or actions of her counterpart. A face-to-face sale of property, where trust is sought and betrayed by one of the participants, is the archetype of conduct actionable under common-law fraud. This archetype is a crude fit when transposed to the world of stock exchanges, brokered transactions, and stock held in “street name” only. Rule 10b-5 is often applied to *impersonal* transactions where the supposedly deceitful or misleading words or actions are never communicated directly to the complaining party. The deceived party’s trust is reposed in “the system,” and her faith in the system is premised on the belief that it is not a rigged game.302

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300. See id. at 673-74.
301. See id. at 677-78.
302. The difficulty that arises in transposing common-law fraud principles to the operation of our securities markets is perhaps most striking in cases involving insider trading. Silence constitutes deception only when there is a duty to speak. The failure of insiders to disclose information in their possession prior to engaging in a securities transaction is fraud under the common law only if the insiders owe a duty to the other party to the transaction. However, strictly speaking, corporate insiders owe a duty to the corporation and not to individual shareholders. See Langevoort, supra note 103, at 870.

Insider trading can occur when insiders purchase stock from existing corporate shareholders while in possession of advance information concerning positive corporate developments. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). Under the common law, the general rule is that insiders owe no broad-based duty to share information with existing shareholders in the corporation when the insiders act in a personal (noncorporate) capacity and the transaction occurs on an open market. See Geller v. Transamerica Corp., 53 F. Supp. 625, 630 (D. Del. 1943), aff’d, 151 F.2d 534 (3d Cir. 1945); Goodwin v. Agassiz, 186 N.E. 659, 660 (Mass. 1934).
that Congress chose to utilize in creating a system of securities regulation tells us more about the appropriate boundaries of the private cause of action on the basis of conduct occurring in this specialized environment than do the policy arguments that have been used to customize the traditional elements of common-law fraud.

Dissatisfied with the course of the federal common law using an approach of modified intentionalism, the Supreme Court has lately shifted toward textualism as a means of interpreting Section 10(b). At this point, the Supreme Court undoubtedly views textualism as the most satisfactory of the three alternative interpretive inquiries outlined above. In theory, textualism combines the guidance of the plain meaning of the text with a certain amount of flexibility in interpreting that meaning. When interpreting a statutory provision that is part of a larger statute, most strict textualists consider it proper to make reference to the remainder of the statute in their reading of the specific provision at issue. In this manner, textualism employs a degree of “structural analysis” that informs the specific statutory language.

However, as applied in the securities law context, the current Supreme Court has placed inordinate weight on the meaning of particular statutory language at the expense of larger structural princi-

1933). Some jurisdictions follow a “special facts exception.” See Goodwin, 186 N.E. at 661. Such an exception makes sense in cases involving face-to-face dealing between the insider and the shareholder or the repose of some special trust due to a preexisting relationship. However, in either event the “special facts” would only exist where the stock transaction was executed in person and not anonymously over an impersonal exchange. A minority of states follow a strict fiduciary rule. See generally Gabaldon, supra note 123, at 160-61 n.40 (citing state-law cases).

Insider trading also can occur when insiders sell corporate stock on advance knowledge of negative corporate developments. Even if insiders owe a common-law duty to existing shareholders when they purchase shares on the basis of nonpublic information, the common law would impose no duty on insiders when they sell shares to persons who are not already shareholders. In the former context, the insiders stand in a preexisting relation to the shareholders, and the question of whether their conduct constitutes deception turns on the scope of that relationship. However, to construe “fraud” to include a duty to disclose even to persons with whom the insiders have no preexisting relationship is a significant relaxation of common-law principles. The SEC has historically argued in favor of reading Section 10(b) to relax common-law principles in this manner in the context of insider trading. See In re Cady, Roberts Co., 40 S.E.C. 907 (1961). In Cady the SEC stated, “We cannot accept ... that an insider’s responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders. This approach is too narrow. It ignores the plight of the buying public—wholly unprotected from the misuse of special information.” Id. at 913. Compare id. with Chiarella v. United States, 445 U.S. 222, 222-23 (1980) (noting that insider trading liability under Rule 10b-5 “is premised upon a duty to disclose ... arising from a relationship of trust and confidence between parties to a transaction . . . . [No duty could arise] from petitioner’s relationship with the sellers of the target companies’ securities, for [petitioner] had no prior dealings with them.”).

303. See supra notes 207-15 and accompanying text.

304. See Eisenberg, supra note 207, at 22; see also United States v. O’Hagan, 92 F.3d 612, 625-26 (8th Cir. 1996) (“fraudulent” conduct prohibited by § 14(e) should be interpreted to be coextensive with the “deceptive” conduct prohibited by § 10(b)), cert. granted, 117 S. Ct. 759 (1997).

305. See Eisenberg, supra note 207, at 22; see also Eskridge, supra note 138, at 41-42 (ascribing such a view to Justice Scalia and characterizing this approach as “holistic textualism”).
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For example, in *Gustafson v. Alloyd Co.*, the minority opinion advocated a textualist interpretation that would have given effect to the plain meaning of the word "prospectus" as utilized in Section 12(2) of the 1933 Securities Act, without regard to the overall structure of that statute and its relation to the Securities Exchange Act. The result would have been the application of a carefully crafted standard of liability well outside of the boundaries of industry practice for which it was designed.

Surprisingly, the majority in *Gustafson*, which rightly concluded that Section 12(2) did not apply to secondary transactions and was limited in application to the context of a primary offering of securities, was unwilling to base its holding solely upon the logical interrelation between Section 12 and the specific underwriting practices that the Securities Act was carefully constructed to regulate. Instead, Justice Kennedy's majority opinion begins with a befuddled discussion of Section 10 of the 1933 Act, which also uses the term "prospectus," in order to read its usage of the term into Section 12. This tactic can be viewed as an attempt to preempt the argument that the Court's holding must be governed by the definition of "prospectus" contained in Section 2(10) of the 1933 Act, an extraordinarily broad definition that is not limited by its terms to primary offerings. However, by engaging in such semantic games, Justice Kennedy allows the textualists to choose the field of battle. In both the majority and the dissent, the Court's reasoning is handcuffed by the Justices' unquestioned acceptance of the premise that the meaning of Section 12(2) must be divined in the first instance from the plain meaning of the statutory language. The unmistakable impression given by the manner in which both the majority and the minority employ a textualist approach is that they are focusing on individual saplings while ignoring the forest.

See also Richard J. Pierce, Jr., *The Supreme Court's New Hypertextualism: An Invitation to Cacophony and Incoherence in the Administrative State*, 95 COLUM. L. REV. 749, 762-63 (1995) (suggesting that recent Supreme Court cases in a variety of subject areas instruct the lower federal courts to apply the plain meaning of a statutory provision, even where such a reading results in a conflict with the remainder of the statute).

306. See also Richard J. Pierce, Jr., *The Supreme Court's New Hypertextualism: An Invitation to Cacophony and Incoherence in the Administrative State*, 95 COLUM. L. REV. 749, 762-63 (1995) (suggesting that recent Supreme Court cases in a variety of subject areas instruct the lower federal courts to apply the plain meaning of a statutory provision, even where such a reading results in a conflict with the remainder of the statute).


309. See 115 S. Ct. at 1066-67; see also Glamorgan Coal Corp. v. Ratner's Group, No. 93 Civ. 7581, 1995 U.S. Dist. LEXIS 9548, at *7 (S.D.N.Y. July 10, 1995) (dismissing claim under § 12(2) because offering document did not need to comply with requirements of § 10 and therefore was not a "prospectus").

310. See *Gustafson*, 115 S. Ct. at 1075 (Thomas, J., dissenting).

311. Cf. ESKRIDGE, supra note 138, at 32 ("The Supreme Court often follows the plain meaning of the statutory text over objections that the literalist interpretation undermines the original intent or purpose of the Congress that enacted the statute.").
Structuralism, a fourth alternative theory of interpreting texts, provides a superior basis for giving content to Section 10(b) than either modified intentionalism or textualism. Structuralism differs from textualism in that it seeks to derive authority from a text while recognizing that the text being interpreted does not explicitly address the subject matter of the inquiry. Unlike a textualist reading of the statute, there is little chance that the operating principles revealed through a close analysis of the statute's overall structure will get tripped up by the definition of individual words contained in the text. In the case of Section 10(b), which has been characterized as having "no intrinsic meaning," it is particularly appropriate to subordinate the specific statutory text to the overall role that private causes of action play within the entire system of securities regulation.

An example of a structuralist interpretation of Section 10(b) can be seen in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson.* *Lampf* sought to define the statute of limitations in a 10b-5 action. Obviously, the Securities Exchange Act does not set forth a statute of limitations applicable to implied causes of action under its terms. The text of Section 10(b) itself is silent on the issue as well. In *Lampf,*

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313. See Charles L. Black, Jr., *Structure and Relationship in Constitutional Law* 7 (1969) (suggesting that the "explication or exegesis of [a] particular . . . passage" of the Constitution should not guide our interpretation of that document, but rather that its meaning should be found in "inference[s] from the structures and relationships created by the Constitution"); Philip Bobbitt, *Constitutional Fate* 74-92 (1982). But see Eskridge, supra note 138, at 7 (arguing that theories of statutory construction are "distinct from, and intellectually independent of," theories of constitutional construction).

314. "Structural arguments are inferences from the existence of constitutional structures and the relationships which the Constitution ordains among these structures." Bobbitt, supra note 313, at 74. For example, it has been argued that a structuralist approach towards constitutional interpretation is perhaps the most satisfactory means of locating a constitutional source for the federal power to control immigration, a power nowhere mentioned in the text of the Constitution. See Thomas Alexander Aleinikoff et al., *Immigration: Process and Policy* 16 (3d ed. 1995) ("Under this view, one does not focus on isolated clauses in the document; instead, the interpreter takes a step back and examines the shape of the Constitution as a whole: the institutions it creates and the relationships between those institutions.").


316. See Grundfest, supra note 222, at 41.

317. It may be accurate to describe the normal process of statutory construction as an "interaction between interpreter and text that creates new and perhaps unexpected meaning over time." See Eskridge, supra note 138, at 62. However, where the text itself is devoid of content, this "interaction" is more akin to the sound of one hand clapping. The choice of a structuralist approach resolves this interpretive dilemma. But see Stern, supra note 128, at 3 (arguing that the "constitutionalization" of the interpretive methods used to construe § 10(b) results in an inappropriately narrow reading of the cause of action).


319. See id. at 358.
the Supreme Court constructed a statute of limitations for the cause of action under Section 10(b) solely on the basis of the operating principles that it divined from the express causes of action contained in the securities laws. As a result of this inquiry, the Court concluded that the appropriate statute of limitations was one year after discovery of the fraud, with a three-year period of repose.320

The Supreme Court engaged in a similar structuralist interpretation of Section 10(b) in Musick, Peeler & Garrett v. Employers Ins. of Wausau,321 when it held that a right of contribution exists in an implied private action under Section 10(b).322 In that case, the Court looked to the express causes of action and stated that “consistency requires us to adopt a like contribution rule . . . under Rule 10b-5.”323 However, in Central Bank of Denver, the majority opinion discussed the approach utilized in both Lampf and Musick only after it had concluded that the text of Section 10(b) itself resolved the question.324 The Central Bank of Denver Court missed an opportunity to clearly embrace structuralism as a rule of decision and unwisely decided to pursue a textualist approach that relies heavily upon the specific language contained in Section 10(b).

The statutory language contained in any one provision of the securities laws is susceptible to interpretations that subvert the carefully designed structure of the securities laws, as demonstrated by the dissent's reasoning in Gustafson.325 Instead, any attempt to interpret Section 10(b) should give primacy to the overall structure of both the 1933 Securities Act and the Securities Exchange Act of 1934. A structuralist interpretation of Section 10(b), rather than the more narrow textualist approach, provides the best available method to restrict the wide-ranging discretion that the judiciary otherwise possesses in the interpretation of an implied private cause of action.326

2. Principles Derived from a Structuralist Interpretation

It is possible to derive certain basic principles relating to the conduct that should be subject to private liability under Section 10(b) from the role that the explicit causes of action contained elsewhere in the securities laws play within the overall structure of federal regulation. A “structuralist” interpretation of the securities laws would define the cause of action under Section 10(b) by giving primacy to these

320. See id. at 359-61.
322. See id. at 297.
323. Id.
326. See Gabaldon, supra note 71, at 1081-87 (discussing the use of express private rights as models for the implied right under § 10(b)); see also Gabaldon, supra note 123, at 204 (suggesting that attention to the structure of the express causes of action contained in the securities laws provides an analogy that may illuminate congressional intent regarding § 10(b)).
principles over other possible sources of meaning.\textsuperscript{327} It is suggested that a structuralist interpretation of Section 10(b) should provide the framework for congressional efforts at codification.\textsuperscript{328}

This approach might be criticized as yet another misguided search for original intent. One could argue that codification efforts should be directed toward transcribing the unobjectionable components of the cause of action as developed via federal common law. However, there are two reasons why it is preferable for the present day Congress to seek guidance from the intent of the 1933 and 1934 Congresses, as revealed in the structure of the Acts, rather than from modern judicial interpretations of Section 10(b). First, to the extent that securities fraud jurisprudence contains internal inconsistencies or allows Section 10(b) to operate in a manner alien to the remainder of the federal securities laws, a transcription using current jurisprudence as a starting point risks perpetuating these defects. Second, Congress in the 1930s was in the thick of an unprecedented economic crisis and was intimately aware of the industry practices and speculative excesses that had led to such a debacle. Congress's solution, a sweeping regulation of the securities industry, was carefully designed to work as an integrated statutory whole\textsuperscript{329} while, at the same time, avoiding any needless expansion of federal law. The decisions made at that time concerning the appropriate role that private litigation should play in the enforcement of the securities laws need not be slavishly observed today, but such decisions provide a useful point of departure for contemporary efforts to codify Section 10(b).\textsuperscript{330}

\textsuperscript{327} See Gabaldon, supra note 71, at 1083-84; see also Ellis v. Carter, 291 F.2d 270, 273-74 (9th Cir. 1961) (rejecting structural interpretation of § 10(b) in order to avoid "judicial rewriting of the 1934 Act to include procedural provisions which appear only in the 1933 Act").

\textsuperscript{328} See Gabaldon, supra note 71, at 1084 ("A judicial attempt to apply Rule 10b-5 along the lines of the express models ... would seem to be completely reasonable and, from a standpoint of consistency, quite desirable.").

\textsuperscript{329} See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 360-61 (1991). The Lampf Court characterized the express causes of action contained in the 1934 Act as follows:

Each is an integral element of a complex web of regulations. Each was intended to facilitate a central goal: "to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges."

\textit{Id.} (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976)).

\textsuperscript{330} See Thel, supra note 144, at 409-10 (noting that the "analytical model of the stock market that prevailed during the depression was very different from the current model"); cf. Lampf, 501 U.S. at 361-62 (choosing statute of limitations for 10b-5 actions derived from original express causes of action, rather than 1988 Insider Trading and Securities Fraud Enforcement Act). The Lampf Court stated, "We can imagine no clearer indication of how Congress would have balanced the policy considerations implicit in any limitations provision than the balance struck by the same Congress in limiting similar and related protections." \textit{Id.} at 359. There is no reason why our present Congress should not look to the balance struck by its predecessor when seeking to codify a private cause of action under Section 10(b) that would best mesh with the remainder of the securities laws. The axiom "patriots are not made in times of peace" appears
As originally drafted, the Securities Exchange Act of 1934 contains several express private rights of action for the violation of its provisions. Section 9 prohibits manipulation of securities registered on a national exchange. Section 16 prohibits "short swing" trades. Section 18 prohibits false or misleading statements in any application or report filed with the Securities and Exchange Commission under the Exchange Act. Finally, Section 20 imposes liability on "controlling persons" for violations of the Exchange Act committed by persons under their control. As has been noted elsewhere, "[t]hese remedies were carefully constructed and balanced; they extended relief beyond common-law protections, but the tradeoff was the imposition of tight procedural restrictions and a short statute of limitations."

A comparison with the circumstances and conduct that Congress saw as justifying an express cause of action under the 1933 Securities Act is also instructive. Like the express causes of action in the 1934 Act, these actions were created to give rise to liability beyond the common law, specifically in the context of a public offering. Section 11 prohibits false statements and omissions in a registration statement. Section 12 prohibits sales of unregistered securities as well as false statements or omissions made either orally or in a prospectus. Finally, Section 15 imposes liability on "controlling persons" for violations of the Securities Act committed by persons under their control. The placement of a public offering through the use of an underwriting syndicate was a historical development that evolved in the absence of federal regulation, and the 1933 Securities Act was drafted to reflect and accommodate preexisting industry practice.

apt under these circumstances. A corollary might be "successful legislative solutions cannot be crafted in the absence of lawful evils."

333. Id. § 78p.
334. Id. § 78r.
335. Id. § 78t.
336. SOLOMON ET AL., supra note 30, at 839.
337. See generally Musick, Peeler, & Garrett v. Employers Ins. of Wausau, 508 U.S. 286 (1993); Grundfest, supra note 7, at 964 n.2.
340. Id. § 77I. However, in Gustafson, 115 S. Ct. at 1067, the Court limited private action under Section 12 to the context of a primary offering.
The express causes of action under the 1933 Securities Act were designed to impose strict liability on certain specified classes of defendants in two situations. Strict liability is imposed for misrepresentations or omissions made in documents whose production is required by the Act. In addition, strict liability is imposed for failing to comply with the procedures for disseminating information about the underlying securities being placed via the public offering, as laid out in Section 5 of the Act.

In the case of a public offering, this heightened standard of conduct, imposing duties beyond the common law, can be justified on two grounds. First, under Section 12, this heightened liability reaches only "sellers" in privity with the purchaser in a public offering. This limited class of potential defendants can reasonably be expected to have access to the issuer-related information of interest to purchasers, as well as some control over its production. Persons who are mere collateral participants in the sale of the public offering, and who thus lack this same access to information about the issuer and the power to control its production, are unlikely to become defendants in an action brought under these provisions. Second, under all of the express causes of action contained in the 1933 Securities Act, the application of a heightened standard of conduct is explicitly tied to the production or the dissemination of specified information in connection with a public offering. Persons who do not engage in this well-defined type of activity need not fear liability under these heightened standards.

The express causes of action contained in the 1934 Securities Exchange Act can be understood in a similar manner. They also create heightened standards of conduct beyond that which is required by the common law in circumstances where the defendant falls within a specified class of market participants or where the defendant engages in well-defined conduct associated with market professionals. Persons who are not within the specified class, or who are not engaged in activity common to market professionals, should be held to traditional

342. However, there is an affirmative defense if the defendant can show lack of loss causation. See, e.g., Securities Act of 1933, § 11(e), 15 U.S.C. § 77k(e).
343. The word "sellers" encompasses the person who transfers title to the security offered, as well as brokers and others who solicit offers to purchase the security in exchange for financial remuneration. See Pinter v. Dahl, 486 U.S. 622 (1988).
344. However, persons who derive a personal benefit from assisting the placement of a public offering may become liable under Section 12 as a "statutory seller" even when they are not in privity with the purchaser of the securities. See Pinter, 486 U.S. at 647 n.23 (interpreting § 12(1)); Wilson v. Saintine Exploration & Drilling Corp., 872 F.2d 1124 (2d Cir. 1989) (interpreting § 12(2)).
345. See Gabaldon, supra note 71, at 1054-55, 1059-60 (summarizing §§ 11 and 12 as being directed towards deterrence and not compensation).
347. See Gabaldon, supra note 71, at 1062-63 (suggesting that the strict reliance and causation elements of the § 18 private cause of action are intended to keep potential liability within acceptable bounds in the absence of a privity requirement).
standards of conduct. Therefore, before liability is imposed on individuals falling into the latter category, a plaintiff should satisfy all of the requirements of the common law.

This analysis suggests that the Securities Exchange Act was intended to create a standard of liability for private actions under federal law that differs at times from the standard of liability under state common law, but which does not displace it. For example, private actions under Section 10(b) should extend relief beyond the protections of common-law fraud, but not in the context of privately negotiated transactions involving face-to-face dealings between the buyer and seller.\textsuperscript{348} Past judicial constructions of Section 10(b) that relax the common-law standards of liability without reference to the public or private cast of the conduct at issue are misguided. However, it is similarly misguided to read the antifraud provisions of the Securities Exchange Act in a purely textualist fashion in order to conclude that the language therein prohibiting "fraudulent" and "deceptive" acts must, of necessity, limit recovery for nondisclosures to instances where a fiduciary duty has been violated.\textsuperscript{349} The structure of the Securities Exchange Act indicates that, in certain circumstances, the 1934 Congress sought to apply a more stringent standard of conduct to market actors than the state law of fiduciary duties would otherwise impose.

3. \textit{Structuralism Applied: The Case of Reliance}

The relaxation of the reliance element in a 10b-5 action is but one example of how the vagaries of the federal common law have contributed to liability being imposed in the implied private action upon classes of defendants and types of conduct that fall outside of the boundaries of liability established by the structure of the express causes of action.\textsuperscript{350} Blaming the plaintiffs' bar for all that is wrong with securities fraud litigation, or trying to reform private litigation via the new procedural hurdles contained in the Private Securities Litigation Reform Act, is beside the point. As Professor Grundfest observed in relation to the "fraud on the market" theory:

Some securities are intrinsically volatile because of the issuer's business characteristics. If the legal system cannot accurately distinguish certain types of honest volatility from volatility caused by fraud, then plaintiffs' counsel have a rational and legal incentive to sue issuers who are innocent of fraud but who will have a hard

\textsuperscript{348} See also Letsou, supra note 308, at 124-32.


\textsuperscript{350} See LASH, supra note 6, at 12; cf. Carney v. Mantuano, 554 N.W.2d 854, 857 (Wis. Ct. App. 1996) (requiring a showing of reliance under Wisconsin blue sky law). Another possible example is the manner in which courts have interpreted the "causation" element of the cause of action. See Gabaldon, supra note 71, at 1049-50; cf. Lucas v. Downtown Greenville Investors, 671 N.E.2d 389, 400 (Ill. Ct. App. 1996) (holding that no showing of loss causation required under Illinois blue sky law).
time proving that fact... Viewed from this perspective... it is
the system that is wrong. 351

A structural interpretation of the Securities Act and the Securi-
ties Exchange Act leads to the conclusion that Congress, in the after-
math of the stock market crash of 1929, sought to impose federal
regulation over the operation of the securities markets within clearly
defined boundaries. Section 10(b) "protects investors," but it does so
by prohibiting deceptive practices that are inextricably related to the
practices of participants in the securities industry. Because the 1933
and 1934 Acts are explicit in denying any intention to preempt ex-
sting state law, 352 fraudulent conduct in a face-to-face transaction be-
tween individuals who are both unconnected to the securities industry
and not engaged in a regular process of capital raising should at least
be subject to the rigorous standards of a state law action for deceit. 353

Congress deliberately included a reliance requirement when it
drafted Section 18 of the Securities Exchange Act, which provides a
private cause of action for misleading statements contained in a filing
required by the SEC. 354 The relaxation of the reliance element in the
analogous 10b-5 action is an unmerited departure from the overall
structure of the securities laws. Admittedly, certain express causes of
action in the 1933 Securities Act either contain no reliance require-
ment or employ justifiable reliance as an affirmative defense, rather
than as an element of the plaintiff's claim. 355 However, these are all
express causes of action reaching a limited class of possible defend-
ants—either a defined group of market professionals or company in-
siders, on the one hand, or persons in privity with the plaintiff. 356 The
decision to place the burden of proof on the defendant in these ac-
tions must be understood in light of the specific position that the de-
fendant has in the securities marketplace. Section 10(b) reaches a far
broader class of defendants than those who can be categorized as cor-
porate insiders or market professionals, and it reaches fraudulent ac-
tors even where they do not deal directly with the plaintiffs.

Therefore, it is appropriate to interpret the 10b-5 cause of action to

351. Grundfest, supra note 14, at 735.
353. See Marine Bank v. Weaver, 455 U.S. 551 (1982) (holding that transaction did not in-
volve the sale of a security because of the private nature of the transaction); see also Letsou,
supra note 308, at 124-32.
(White, J., dissenting).
355. Section 11 has no reliance requirement unless the plaintiff purchased the security more
than 12 months after the effective date of the registration statement. See Hazen, supra note 71,
at 331. Section 12 does not require reliance as an affirmative part of the plaintiff's case, but a
defendant can avoid liability by showing that the plaintiff knew of the fraud at the time of
purchase and therefore could not have relied upon the misrepresentation. See id. at 355.
356. See Securities Act of 1933 §§ 11(a) & 12, 15 U.S.C. §§ 77k(a) & 77l.
require a higher reliance requirement than the express causes of action in the 1933 Act. 357

The burden of proof to demonstrate reliance should not be removed from the plaintiff’s shoulders in a 10b-5 action. Before being allowed to recover, each plaintiff in a private action under Rule 10b-5 should be required to show actual reliance on the misrepresentation or omission. 358 Plaintiffs also should be required to demonstrate that they exercised due diligence, to the extent reasonable under their individual circumstances, in order to verify the representations made to them. 359 The reliance element should incorporate a demonstration of due diligence, whether or not the plaintiff has been placed on notice of possible fraud by the presence of certain red flags. Sophisticated plaintiffs, and those represented by sophisticated professionals in a securities transaction, should rightly be expected to exercise a greater degree of due diligence than unsophisticated plaintiffs in order to establish reliance.

Following the above analysis, the “fraud on the market” theory of liability, which allows a plaintiff to rely upon the integrity of the market price of the security without knowledge of the misrepresentation or omission by the defendant, is a similar example of improper relaxation of the reliance element in 10b-5 actions. Such relaxation is contrary to the structure of the express causes of action. 360 The “fraud on the market” theory allows severe fluctuations in the price of corporate stock to be challenged by the assertion that the movement in price was the result of either inaccurately disclosed information or a fraudulent delay by corporate officers in disclosing information to the market. “Fraud” is therefore defined without the existence of any direct reliance upon the defendant’s representations and in terms totally separate from the subjective state of mind of the allegedly deceived plaintiff. 361 Supporters of the theory argue that the “deception” occurred when the plaintiff placed faith in the stock price as an accurate indicator of the stock’s value, and that the theory is justified by the broad

357. See also Gohler v. Wood, 919 P.2d 561, 565 (Utah 1996) (holding that privity requirement contained in antifraud provisions of Utah Securities Act obviates need to interpret statute to require showing of reliance).

358. See Carr v. CIGNA Sec., Inc., 95 F.3d 544, 547 (7th Cir. 1996).

359. See Harasco Corp. v. Segui, 91 F.3d 337, 344 (2d Cir. 1996) (sophisticated purchaser cannot rely on statements by seller that were specifically disclaimed in purchase contract); Shores v. Sklar, 647 F.2d 462, 483 (5th Cir. 1981) (Randall, J., dissenting) (“[T]he federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make. This system is not furthered by allowing monetary recovery to those who refuse to look out for themselves.”); see also McCormick v. Fund Am. Cos., 26 F.3d 869 (9th Cir. 1994); Jensen v. Kimble, 1 F.3d 1073 (10th Cir. 1993).


361. See Basic Inc. v. Levinson, 485 U.S. 224, 256 (1988) (White, J., dissenting) (“[T]oday, the Court allows investors to recover who can show little more than that they sold stock at a lower price than what might have been.”); see also Phillips & Miller, supra note 24, at 1032-33.
remedial purposes that motivated Congress in passing Section 10(b).\textsuperscript{362}  

However, recent empirical research suggests that imposing Section 10(b) liability on the basis of the "fraud on the market" theory is fundamentally inconsistent with the normal price volatility experienced by the stock of emerging high-tech companies.\textsuperscript{363}  Companies in emerging industries like biotechnology or advanced telecommunications often encounter high development costs and technological challenges that combine to create product delays and cost overruns. Future earnings of such companies are often speculative, leading to situations where the market substantially reevaluates the company's future prospects on the basis of small pieces of information. The market price of the company's stock may be informationally efficient but may not allocate that information efficiently.

Moreover, the existence of the "fraud on the market" theory of liability exposes companies in some industries to a systemic market risk of litigation based on large price swings. These price swings, common for start-up companies in high-tech industries, are unforeseeable in regards to any individual company within the industry and are therefore unpreventable.\textsuperscript{364}  The risk of litigation thus becomes a cost borne by all companies within that industry, regardless of the integrity of their management or the adequacy of their internal controls. There is a risk that capital raising within these industries could be impeded as a result of this cost.\textsuperscript{365}  

One might question whether the law should presume the plaintiff's right to rely on the accuracy of the market price of a company's stock, when such a theory seems to be at odds with the normal workings of the securities market in certain emerging industries.\textsuperscript{366}  More importantly, economic theories concerning the operation of efficient


\textsuperscript{363} See Coffee, supra note 18, at 5 (noting research suggesting that stock volatility often precedes the filing of a securities class action complaint); see also Phillips & Miller, supra note 24, at 1012-13.

\textsuperscript{364} See Grundfest, supra note 7, at 973 n.40 (noting that "[a]lmost one-third of all publicly traded biotechnology companies have been sued in securities class actions").

\textsuperscript{365} See Phillips & Miller, supra note 24, at 1028.

\textsuperscript{366} As discussed above, some have attacked the empirical underpinnings of the Efficient Capital Markets Hypothesis, on which the "fraud on the market" theory, in turn, is premised. See supra note 48. For an argument that the boom in successful initial public offerings belies any detrimental effect of the securities laws on capital formation in emerging industries, see Seligman 1, supra note 14, at 440. The relevance of successful IPOs to the litigation costs borne by companies in emerging industries has been questioned, however. See Grundfest, supra note 14, at 730.
markets underlie the "fraud on the market" theory.\textsuperscript{367} None of the express causes of action created by Congress in the securities laws reflects a congressional concern with the economic theory behind movements in stock price.\textsuperscript{368} Instead, the express causes of action are designed to work in conjunction with contemporaneously imposed requirements to disclose specified information. Congress was not concerned with crafting a federal law that would apply to all information, regardless of whether the mandatory disclosure provisions were implicated.\textsuperscript{369} Elevating economic theory to an exalted level in the definition of the private cause of action is inappropriate.

Despite the federal government's interest in a national securities market, federalism concerns should counsel against the displacement of state law standards of liability in the context of isolated securities transactions between private individuals that do not implicate the overall scheme of mandatory disclosure.\textsuperscript{370} Federal law should displace state-law standards of liability only where the conduct regulated has a more "public" cast: instances involving public offerings or transactions conducted by market professionals and other regular and well-defined market actors, such as the officers and directors of publicly traded companies.\textsuperscript{371} These are the situations where Congress intended to create heightened standards of conduct.\textsuperscript{372}

The present scope of Rule 10b-5 liability extends far beyond the range of activity that Congress sought to reach via the express causes of action in the 1933 and 1934 legislation. The dissonance between the scope of Rule 10b-5 liability and the structure of the securities laws is significant given the care that Congress gave to constructing statutes that were closely tailored to the operation of the securities


\textsuperscript{368} But see Thel, supra note 144, at 392 (arguing that one plain meaning of § 10(b)'s language may be to prohibit any act that threatens the integrity of security prices). Congress has a greater understanding of economic theory underlying stock price movements today than it had in 1934. See H.R. CONF. REP. No. 104-369, at 742 (1995) ("Technology companies—because of the volatility of their stock prices—are particularly vulnerable to securities fraud lawsuits when projections do not materialize.").

\textsuperscript{369} Cf. Marine Bank v. Weaver, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.").

\textsuperscript{370} Cf. id. at 559 (contract akin to a "private transaction" held not to be a security); see Gabaldon, supra note 123, at 162-69.

\textsuperscript{371} Cf. Gustafson v. Alloyd Co., 115 S. Ct. 1061, 1073 (1995). In interpreting Section 12 of the 1933 Securities Act, the majority stated that "[i]n light of the care that Congress took to justify the imposition of liability without proof of either fraud or reliance on 'those whose moral responsibility to the public is particularly heavy,'—the 'originators of securities'—we can not conclude that Congress would have extended that liability to every private or secondary sale without a whisper of explanation." Id.

\textsuperscript{372} Cf. H.R. REP. No. 73-85, at 5 (1933), quoted in Gustafson, 115 S. Ct. at 1072.
markets. Reform efforts in the realm of securities litigation should focus on removing this dissonance, so that the implied private right of action to recover for securities fraud will be more closely integrated into the structure of the Acts as a whole.

B. The Merits of Codification

Elimination of the dissonance between current 10b-5 jurisprudence and the overall structure of the Acts, including the express causes of action contained therein, cannot occur via the common-law decision-making process. One unlikely alternative, despite the present low regard exhibited toward Cort v. Ash and implied private rights of action under federal law, is the elimination of the cause of action altogether by the judiciary. The Supreme Court appears to recognize that we have gone too far down this road to turn back now.

In addition, there is no denying the proven utility of some measure of private enforcement under Section 10(b) as an aid to the policing of the securities markets by the SEC. It is true that some private actions target borderline conduct that the Commission would decline to prosecute even if it had unlimited resources. However, the existence of the private right of action allows the SEC to direct its investigative and trial manpower toward selected areas of conduct, such as insider trading, while relying on the plaintiffs' bar to police the more "garden variety" fraudulent conduct. The complete elimination of the private cause of action would be acceptable, from an enforcement standpoint, only if accompanied by a massive increase in funding and resources for the SEC. Even under those circumstances,
doubts would remain as to whether purely public enforcement is as efficient a deterrent as a combination of public and private enforcement.

Furthermore, the judiciary is not an appropriate institution for the wholesale rejection of current securities fraud jurisprudence and its replacement with a newly crafted cause of action. The Supreme Court's own opinions discussing implied private rights of action recognize that the creation of a cause of action, ab initio, is essentially a legislative function. Any judicial attempt to restate the cause of action in its entirety would suffer from a judicial process that, in comparison to the legislative process, lacks complete access to relevant information and excludes the participation of the entire affected population.

The piecemeal reform of the cause of action, through an ongoing judicial reinterpretation of Section 10(b), also appears unsatisfactory. For one, the vagaries of the federal common law coupled with the lack of congressional guidance ensure that future interpretations of the existing implied cause of action will continue to be subjected to the shifting tides of judicial philosophy. Judicial decisions seeking to reform the current scope of Rule 10b-5 litigation must coexist uneasily with contradictory prior precedent. The result is a cause of action divided against itself, with elements defined using disparate policies, principles, and reasoning as a touchstone. Continued adherence to a textualist approach will serve only to mask these contradictions. A further change in course to reject textualism would exacerbate them.

In addition, the inherent deficiencies of the common-law process counsel against piecemeal judicial reform as an alternative. By its nature, the judiciary must define the elements of a 10b-5 action through individualized cases raising narrow issues and involving specific parties. There is a sense of immediacy to the debate over the future of private securities litigation that cannot be satisfied through such a gradual process of reform. A selective overruling of prior precedent would take time, would involve widely disparate fact patterns,

possible societal response is deregulation of the industry coupled with increased private enforcement. See id.; Fallone, supra note 34, at 863-64 (noting Breyer's argument in support of such an approach to antitrust enforcement). By the same token, it must be recognized that imposing significant limitations on the utility of the private cause of action as a means of legal enforcement will inevitably place a greater regulatory burden on the governmental entity charged with policing the industry and remediaying the market failure.

379. See, e.g., Musick, Peeler & Garrett, 508 U.S. at 291 ("[T]he creation of new rights ought to be left to legislatures, not courts.").

380. See supra text accompanying notes 216-35.

381. Recall that the decision in Plaut v. Spendthrift Farm, Inc., 115 S. Ct. 1447 (1995), determining the statute of limitations applicable to 10b-5 claims brought prior to 1991, came four years after the Supreme Court's Lampf decision, which was itself the culmination of years of litigation on the issue. See Harvey L. Pitt & Karl A. Groskaufmanis, The Supreme Court's Plaut Decision, LEXIS Counsel Connect, Apr. 21, 1995 (on file with the University of Illinois Law Review).
and would be influenced by the divergent views of present (and possibly future) members of the Supreme Court. Such a process is therefore unlikely to result in a timely reinterpretation of Section 10(b) on the basis of consistent principles.

Codification serves the dual functions of preserving the private right of action from the prospect of incremental judicial erosion while providing the opportunity for a principled pruning of its most expansive applications. The antifraud private right of action plays a vital role in the enforcement of securities regulation; its complete abolition would be unthinkable, given the impossibility of government regulators alone policing such a vast market. By the same token, the private cause of action as it has developed through the federal common law should not be considered sacrosanct: policy makers should not hesitate to use codification to narrow the scope of the Rule 10b-5 cause of action so that it fits more clearly within the overall structure of the Securities Act of 1933 and the Securities Exchange Act of 1934.

At least one commentator has argued that the SEC should pursue disimplication of the private cause of action through a “concept release” that would precede an administrative rulemaking. Under this approach, the SEC would reevaluate the appropriate scope of the cause of action and replace the current language of Rule 10b-5 with more explicit provisions. It is true that Section 10(b) is essentially a delegation of authority to the SEC. However, disimplication and substitution via an SEC rulemaking cannot resolve the current debate concerning the scope of private actions brought under Section 10(b).

First, even if the SEC were to substitute a new rule for the current text of Rule 10b-5, the Supreme Court would continue to be the final arbiter of the scope of conduct prohibited by the plain meaning of Section 10(b). The authority delegated to the SEC via Section 10(b) is the authority to prescribe specific acts and practices that have been found to be fraudulent; the SEC does not have the authority under Section 10(b) to redefine the elements of fraud itself. Therefore, any new rule seeking to redefine the scope of the private cause of action would be subject to challenge as exceeding the grant of au-

382. See Gabaldon, supra note 71, at 1098.
383. See Grundfest, supra note 7, at 965-66 (suggesting that the SEC has the authority to limit private claims under 10b-5 to a scope smaller than currently recognized under the law, while retaining its own enforcement authority over a broader scope of conduct); Grundfest, supra note 14, at 729 (“Professor Seligman’s effort to dismiss further inquiry into fundamental reform as unnecessary is . . . premature at best . . . .”); David Ratner, Appealing for the Repeal of Rule 10b-5, RECORDER, May 26, 1992, at 8, available in LEXIS, Genfed Library, Rcrdr File. But see Cunningham, supra note 42, at 1444 (stating that the appropriate response to the prospect of undue civil liability under Rule 10b-5 is to police the conduct of attorneys, rather than “redefining substantive obligations under the securities laws”).
384. See Grundfest, supra note 7, at 1023-24.
authority contained in Section 10(b). Supreme Court precedent defining the permissible scope of private liability, and all of its internal contradictions, would be left untouched by the SEC rulemaking.\footnote{386. Notwithstanding the deference that reviewing courts are obligated to accord agency constructions of statutes pursuant to the agency's delegated authority, see Chevron U.S.A., Inc. v. National Resources Defense Council, Inc., 467 U.S. 837 (1984), it appears unlikely that such deference would extend to a substituted text of Rule 1Ob-5 that exceeds the boundaries of Section 10(b) as described in the Court's prior rulings. See O'Hagan, 92 F.3d at 627-28. But see Grundfest, \textit{supra} note 7, at 984-85, 1011-14. For example, the Commission would be precluded from promulgating a substituted Rule 1Ob-5 that provides for aiding and abetting liability.} An administrative disimplication would merely add one more potential layer of complexity to the already difficult task of interpreting the private cause of action.\footnote{387. \textit{See Conference on the Codification of the Federal Securities Laws}, 22 \textit{Bus. Law.} 793, 797 (1967).} 

Second, it appears likely that in the near future Congress will have to take up the task of codifying the prohibition on insider trading. Both the Fourth Circuit, in \textit{Bryan},\footnote{388. United States v. Bryan, 58 F.3d 933, 944, 952 (4th Cir. 1995).} and the Eighth Circuit, in \textit{United States v. O'Hagan},\footnote{389. 92 F.3d 612, 618 (8th Cir. 1996), \textit{cert. granted}, 117 S. Ct. 759 (1997).} have held that the plain meaning of Section 10(b) does not permit the government to use the misappropriation theory as a basis for imposing liability for insider trading. The \textit{O'Hagan} court went further and held that Rule 14e-3(a), prescribing insider trading in connection with tender offers, is an impermissible exercise of the SEC's rule-making authority.\footnote{390. \textit{See id. at} 627.} The analysis in both \textit{Bryan} and \textit{O'Hagan} is heavily influenced by the Supreme Court's textualist pronouncements in the \textit{Central Bank of Denver} case. The Supreme Court has been asked to resolve this split in the circuits,\footnote{391. The validity of the misappropriation theory was recently reaffirmed by the Second Circuit. \textit{See United States v. Mylett}, 97 F.3d 663, 667 (1996).} and it appears doubtful that the textualist approach favored by current members of the Court will look kindly upon either the misappropriation theory or Rule 14e-3(a).

Congress is unlikely to accept the relatively narrow scope of insider trading conduct that would be subject to prosecution in the absence of the misappropriation theory and Rule 14e-3(a).\footnote{392. \textit{See Report of the Task Force on Regulation of Insider Trading}, 41 \textit{Bus. Law.} 223, 225 (1985). It appears that a textualist method of interpretation bodes ill for the future of the misappropriation theory under the Supreme Court's construction of Section 10(b)'s current language. In contrast, Congress expressed approval of the misappropriation theory when it enacted the 1988 Insider Trading and Securities Fraud Enforcement Act. \textit{See Gabaldon, \textit{supra} note} 71, at 1093.} The logical solution to judicial decisions abrogating these grounds of liability would be a fresh effort to codify the scope of conduct held to constitute insider trading. By forcing Congress to revisit the codification of insider trading liability, the \textit{Bryan} and \textit{O'Hagan} decisions also provide a valuable opportunity for Congress to address the codification of private litigation under Section 10(b) in general.
Therefore, congressional codification, rather than agency action, is a preferable vehicle for the reform of the private right of action under Section 10(b). Prior, albeit unsuccessful, efforts have been made to codify the provisions for securities fraud. Some observers have been quick to dismiss a possible role for Congress in the reform of Section 10(b) jurisprudence. Critics have suggested that such a task is too "politically charged," "contentious," "labor-intensive," or "intricate" for Congress to undertake. However, the codification of a private cause of action for securities fraud goes to the heart of the structure and purposes of the securities laws and, as such, is inappropriate for delegation to an administrative agency like the SEC. Basic rights and obligations of citizens should be defined by the citizens' elected representatives.

Congress would be aided in its task by a large body of precedent and academic literature, by the ALI's Proposed Federal Securities Code, by its prior efforts to codify the prohibition against insider trading, by the debate over the initial drafts of the Private Securities Litigation Reform Act, and by analogous code provisions in other countries. The possible alternative formulations of the private cause of action are readily discernable. In addition, Congress has evidenced a willingness of late to reassert itself in the context of securities regulation, as opposed to its past practice of abdication to the judiciary. If Congress is capable of instituting fundamental changes in other areas of the securities laws by, for example, crafting legislation that will preempt state securities laws in significant new ways, then Congress is capable of codifying the scope of conduct that will give rise to liability under the private cause of action for securities fraud.

393. See generally Steinberg, supra note 14, at 516-17. But see Lewis D. Lowenfels, The Case Against the Proposed Federal Securities Code, 65 VA. L. REV. 615, 655-60 (1979) (arguing that the ALI's Proposed Federal Securities Code was not "essential" and was therefore unwise).


395. See Grundfest, supra note 7, at 1019 (citing past congressional efforts that were stymied by "gridlock"); Grundfest, supra note 14, at 744 (expressing doubt that a "purely political resolution" of this debate is possible); Langevoort, supra note 268, at S-19; Ruder, supra note 26, at 1486-87.

396. See Grundfest, supra note 7, at 966-67 (suggesting that any reform of the substantive reach of the private cause of action should be undertaken through SEC rulemaking).

397. Congress recently passed legislation intended to preempt state oversight of mutual funds and scale back state regulation of primary offerings by large corporations. See supra notes 10-12 and accompanying text. Other provisions contained in this legislation include a grant of authority to stock brokers to execute as many as 10 trades per year on behalf of preexisting clients in states where the brokers are not licensed, and elimination of federal supervision over investment advisory firms and their employees when those firms manage less than $25 million. See id.; see also Jeffrey Taylor, Critics Look to Tone down Securities Bill, WALL ST. J., July 1, 1996, at A16.
The current political environment also may favor the congressional codification of the securities fraud private right of action. Members of the plaintiffs' bar might prefer codification within certain boundaries that, at a minimum, ensure the survival of some meaningful private enforcement. They may believe that, over time, the Supreme Court's textualist approach to the interpretation of Section 10(b) will succeed in limiting the scope of the 10b-5 cause of action far more than any legislative effort to define its boundaries. Similarly, recent judicial interpretations of Section 10(b) that threaten the SEC's enforcement authority may convince the agency of the advantages of codification. In addition, the SEC no longer appears to support an overly expansive private enforcement mechanism and may welcome a congressionally defined remedy with a less ambitious scope than currently exists.

Congressional efforts at reform around the edges of private litigation, like the Private Securities Litigation Reform Act, cannot resolve the current debate concerning the private cause of action. Only by tackling head on questions concerning the content of the cause of action can the cause of action be redefined in a manner consonant with the rest of the securities laws. It is incumbent on Congress to revise Section 10(b) in order to fully set forth the conduct that is to be considered fraudulent under Section 10(b), the class of potential defendants who will be held liable for such conduct under federal law (as opposed to existing state law), and the class of investors eligible to recover damages for that conduct. Such an approach would be the inverse of the current course chosen by Congress, which is to largely leave the definition of fraud to the courts and to either (1) abrogate those few rulings where Congress believes that the courts have gone too far, or (2) place procedural restrictions on would-be plaintiffs that hamper both meritorious and nonmeritorious claims.398

VI. Conclusion

The time has come to recognize that the use of the federal common law to define the contours of 10b-5 liability has been a failure.399 The purpose of this article is not to suggest that the present state of securities fraud jurisprudence is the result of one wrong turn in the dynamic interpretation of congressional language. Federal common

398. Cf Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 293-94 (1993). Congress has done the same thing in the context of insider trading, a variant of 10b-5 liability. But this exercise of judicial lawmaking is even more deplorable, because the courts are the primary expositors, through the common-law method, of criminal liability.

399. Long ago, one of the preeminent scholars in this field confessed to being "ashamed" at this process of "backdoor jurisprudence." See Louis Loss, History of S.E.C. Legislative Programs and Suggestions for a Code, 22 BUS. LAW. 795, 796 (1967). Judge Easterbrook's characterization of jurisprudence relating to the subject of the 10b-5 statute of limitations—"one tottering parapet of a ramshackle edifice"—has become an increasingly appropriate epithet for the private cause of action as a whole. See Norris v. Wirtz, 818 F.2d 1329, 1332 (7th Cir. 1987).
law has failed precisely because the lack of any clear direction from Congress within the statutory text makes misinterpretation a virtual impossibility. The vague language of Section 10(b) and Rule 10b-5 can support almost any proffered reading. As a result, the parameters of the private cause of action for securities fraud are defined by a Gordian knot of contradictory policy goals and shifting interpretive methodologies. Each of the steps in this process can be defended persuasively, but a principled defense of the whole—in its present form—is impossible. For this reason, codification is a necessary route to reform.

Codification will not foreclose the judiciary's ability to interpret the substituted text in a dynamic fashion. However, codification will give the courts sufficient guidance to cabin the vagaries of their interpretations within acceptable limits. It will allow the participants in the securities industry to better order their conduct in compliance with the law. Codification also presents an opportunity to bring the private cause of action under Section 10(b) back within the borders of the rest of the Securities Exchange Act—borders that it overflowed long ago.

For this reason, codification should proceed along the lines of the express causes of action already present in the securities laws. Investor protection can be accomplished without codifying all of the expansive interpretations that the judiciary has seen fit, from time to time, to give to the elements of the cause of action. In particular, the cause of action should be codified with the goal of ensuring investor protection through the combined public and private enforcement of the federal securities laws as a whole, in conjunction with state law.

Policy makers have long recognized the benefits of integrated mandatory disclosure provisions under the securities laws and the need to avoid excessive duplication of disclosure requirements. The enforcement provisions of the law should be viewed in the same manner. There is no need for a "catch-all" securities fraud provision that displaces other preexisting, and adequate, remedies.

Congress is the appropriate institution to perform this function, because Congress alone can rectify the inability of the current statutory text to be interpreted in a coherent fashion. Gradual reform by the Supreme Court, through the reinterpretation of the text, is subject to the same unpredictable shifts in judicial philosophy and interpretive method that brought us to this point. In addition, the wholesale re-drafting of the private cause of action is a political act that the Court should avoid.

Although the SEC is capable of drafting a substituted text for Rule 10b-5, its handiwork will remain subject to the Supreme Court's shifting attitude toward the construction of Section 10(b). Unless the SEC is satisfied with a substituted cause of action that is narrower, in

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400. See HAZEN, supra note 71, at 119-20.
all respects, than the current judicial interpretation of Section 10(b) provides, the product of a SEC rulemaking will be subject to years of litigation before its validity can be determined. Legislation by Congress suffers no such defects. It also appears likely that Congress will be forced to codify the prohibition on insider trading if it wants to preserve the current scope of insider trading liability from future erosion. The opportunity presented by such an effort should not be wasted. Congress must take up a task that it has successfully avoided for sixty-one years and codify the private cause of action for securities fraud.