1. The development of securities litigation as a lawmaking partnership

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1. INTRODUCTION

Federal securities fraud litigation has an unusual pedigree. Unlike most private litigation, which is based on an explicit statutory private right of action, the securities fraud cause of action was created by the federal courts.[1] The absence of a statute defining the scope of the claim required the courts to play a significant lawmaking role. Although Congress has, in turn, responded, its interventions have been limited in scope and largely deferential to the resulting body of judge made law.

This chapter takes the position that the collaborative process by which Congress and the courts have developed private securities fraud litigation reflects a normatively desirable approach.[2] The chapter terms this approach a lawmaking partnership,[3] and argues that the lawmaking partnership offers distinctive advantages over alternatives such as detailed statutes coupled with a narrow judicial adherence to the statutory text, on the one hand, or a broad delegation by Congress to the courts or an administrative agency, on the other.

The Supreme Court's decision in *Halliburton Co. v. Erica P. John Fund, Inc.* (*Halliburton II*)[4] can be understood within this framework. In *Halliburton II*, the Court considered the continued viability of a judicially created doctrine—fraud on the market ("FOTM"). The Court had previously created FOTM in *Basic Inc. v. Levinson* as a tool to enable plaintiffs in impersonal public capital markets transactions to address the reliance requirement in federal securities fraud class actions.[5]

By enabling the class action, FOTM dramatically changed the nature of private securities fraud litigation and generated large scale cases involving substantial potential damages (Fisch 2013). In turn, these developments led to complaints about the resulting scope of litigation and the potential for litigation abuse (Fisch 1997). Some commentators demanded that the Court reconsider its earlier decision (Brief for

* This chapter was drawn from *Federal Securities Fraud Litigation as a Lawmaking Partnership*, 93 Wash U. L. Rev. 453 (2016). It is excerpted and reprinted here with the permission of the *Washington University Law Review*.

1 Judicial creation of a private right of action occurred during a period in which federal courts implied private rights of action far more readily than they do today.

2 This chapter does not address broader questions about possible constitutional limits on congressional authority to delegate lawmaking power. *See* Arthur (1986).

3 The partnership construct developed in this chapter is conceptually similar to but more bounded than the manner in which Richard Fallon and Daniel Meltzer used the term. Fallon & Meltzer (2007).

4 134 S. Ct. 2398, 2408 (2014).

5 485 U.S. 224 (1988).

Former SEC Commissioners 2014). Commentators also raised concerns in Congress (Levitt 1995).

Although the Court did not revisit the validity of FOTM prior to *Halliburton II*, it responded to claims of abusive litigation by imposing various limits on the private right of action. Similarly, although Congress did not speak directly to the validity of FOTM, it responded by enacting statutory reforms, first in the Private Securities Litigation Reform Act of 1995 ("PSLRA")[6] and then in the Securities Litigation Uniform Standards Act ("SLUSA").[7] Both the Court's decisions and Congress's refinements to the statutory framework reflected a common goal of reducing the prospect of costly and frivolous litigation while maintaining the viability of private litigation as a means of enforcing the disclosure obligations of the federal securities laws.

The Court in *Halliburton II* did not discuss this cooperative enterprise in its opinion, basing its decision instead on principles of stare decisis. Nonetheless, this chapter argues that the Court's adherence to *Basic* can alternatively be justified in terms of a lawmaking partnership. More broadly, this chapter reasons that the Court should use the existence of a lawmaking partnership as a canon of construction in construing the scope of its own lawmaking authority. Where the Court finds evidence of this type of collaborative process, it should be empowered to use policy analysis to determine how best to further Congress's lawmaking objectives rather than limiting its inquiry to the contours of the statutory text. The virtues of this approach extend beyond the issue of FOTM and apply generally to federal securities fraud litigation.

This chapter proceeds as follows. In section 2, the chapter positions *Halliburton II* within the context of the development of private securities fraud litigation. Section 3 conceptualizes the lawmaking partnership and identifies its structural advantages. Section 4 extends the analysis beyond FOTM and uses the example of insider trading regulation to explain the potential value of the lawmaking partnership in enabling Congress, the courts, and the Securities & Exchange Commission ("SEC") to collaborate on the development of federal securities law.

2. HALLIBURTON II AND PRIVATE SECURITIES FRAUD

2.1 Background—The Development of Private Securities Fraud

The general antifraud provision of the Securities Exchange Act of 1934, section 10(b),[8] contains no express private right of action.[9] Nonetheless, the federal courts recognized a private right of action under the statute and the SEC's Rule 10b-5, and subsequently

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6 Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

7 Securities Litigation Uniform Standards Act of 1998, Pub. L. No 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

8 Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2015).

9 In contrast, the federal securities laws contain a number of provisions that create an express private right of action, including sections 11 and 12 of the 1933 Act and sections 9(e) and 18 of the 1934 Act. 15 U.S.C. §§ 77k–l, 78i(e), 78r (2015).

delineated the scope of this judge made cause of action.[10] As the Supreme Court explained, "[w]hen we deal with private [securities fraud] actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."[11]

The Supreme Court's early decisions primarily involved articulating limitations on the scope of a securities fraud claim (Kaufman 1990). Thus, in *Ernst & Ernst v. Hochfelder*, the Court held that a claim could not be predicated upon a showing of mere negligence but required proof of scienter.[12] In *Blue Chip Stamps v. Manor Drug Stores*, the Court limited standing in private litigation to plaintiffs who had purchased or sold securities in connection with the fraud.[13] In *Santa Fe Industries, Inc. v. Green*, the Court rejected an attempt to address a breach of fiduciary duty through federal securities fraud.[14]

Even before the rise of the new textualism, which heightened the importance of a statute's language in its interpretation (Eskridge 1990), the Court grounded these decisions primarily in the text of section 10(b). Policy considerations also played a role, however, in the Court's analysis. Throughout its development of private securities fraud litigation, the Court sought to balance two competing policies—protecting investors and limiting the potential for litigation abuse. In *Blue Chip Stamps*, for example, the Court justified its restriction on the class of potential plaintiffs in terms of "considerations of policy," including a desire to limit the potential settlement value of lawsuits that could not easily be dismissed prior to trial.[15] Similarly, in *Santa Fe*, the Court identified the concern that a more expansive interpretation of 10b-5 would create a "danger of vexatious litigation."[16]

The 1988 *Basic Inc. v. Levinson* decision took a somewhat different approach.[17] First, the Court relied more heavily on policy considerations than was the case in its earlier decisions. Second, investor protection considerations led the Court to espouse a position that expanded the scope of 10b-5 litigation. In *Basic*, the Court concluded that private plaintiffs need not offer direct proof of reliance, but can use the FOTM theory to obtain a presumption of reliance for securities that trade in an efficient market tainted by public misrepresentations. Commentators have described the *Basic* decision as opening the floodgates for private litigation, although, to be fair, this claim is overstated (Fisch 2013). Even in *Basic*, the Court's role was one of reining in more expansive lower court lawmaking (Fisch 2013).

The *Basic* Court explicitly justified its holding on the basis that it was necessary to adapt the common law reliance requirement to the realities of the modern securities markets. Moreover, the Court defended the FOTM presumption not by relying on the statutory text or even congressional intent, but on "considerations of fairness, public policy, and

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10 The starting point was a district court decision which recognized an implied private right of action in 1946. *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

11 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

12 425 U.S. 185, 193 (1976).

13 421 U.S. 723, 731 (1975).

14 430 U.S. 462, 474–76 (1977).

15 *Blue Chip Stamps*, 421 U.S. at 742–44.

16 *Santa Fe Indus.*, 430 U.S. at 478–79 (quoting *Blue Chip Stamps*, 421 U.S. at 740) (internal quotation mark omitted).

17 485 U.S. 224 (1988).

probability, as well as judicial economy."[18] The Court reasoned that it was necessary to "balanc[e] the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Federal Rule of Civil Procedure] 23."[19]

By eliminating the need for plaintiffs to prove reliance directly, *Basic* made the modern securities fraud class action possible. The Court did not act alone, however, in developing the parameters of securities fraud class actions. Congress responded to *Basic* through explicit statutory provisions that clarified and modified the scope of the class action. In 1995, Congress adopted the PSLRA,[20] which reflected both congressional acceptance of the judicially created private right of action and a reassertion of congressional authority over the scope of that right of action. Congress included in the statute a heightened pleading standard, a discovery stay, an explicit loss causation requirement, and refinements to the calculation of damages (Fisch 1997). In addition, Congress adopted a lead plaintiff provision in an effort to respond to the argument that securities fraud class actions constituted "lawyer-driven litigation" by mobilizing institutional investors to act as litigation gatekeepers (Fisch 2005).

Subsequently, in 1998, Congress enacted SLUSA, which preempted state court litigation for "covered class actions" in order to ensure that those cases were subject to the provisions of the PSLRA.[21] Later, as part of the Sarbanes–Oxley Act of 2002, Congress extended the statute of limitations in private securities fraud litigation.[22]

In legislating with respect to private securities fraud, Congress reaffirmed the critical policy considerations that had previously been identified by the Court. Congress explicitly recognized the importance of private litigation as a supplement to public enforcement efforts. Thus, the statement of managers accompanying the conference report for the PSLRA described private securities litigation as "an indispensable tool," both for protecting investors and for "promot[ing] public and global confidence in our capital markets."[23] This policy judgment is consistent with the Court's analysis. As the Court has repeatedly explained, "private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses—a matter crucial to the integrity of domestic capital markets."[24]

At the same time, Congress sought to structure private litigation so as to minimize the potential for vexatious litigation (Fisch 1997). In the PSLRA, Congress chose to retain the private securities fraud class action, but to refine its use by implementing substantive and procedural safeguards against overuse and abuse. These safeguards serve similar policy objectives as the limitations imposed by the Court in cases such as *Ernst*, *Blue Chip Stamps*, and *Central Bank*.

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18 *Basic*, 485 U.S. at 245.

19 Ibid at 242 (internal quotation omitted).

20 Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

21 Securities Litigation Uniform Standards Act of 1998, Pub. L. No 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

22 Sarbanes–Oxley Act of 2002 § 804, 28 U.S.C. § 1658 (2014).

23 H.R. Rep. No 104-369, at 31 (1995).

24 Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 320 n.4 (2007) (internal quotation marks omitted) (citing Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 81 (2006)).

2.2 The *Halliburton* Decision

Halliburton II presented the Court with the question of whether to overrule its prior decision in *Basic*.[25] The petitioner argued that academic consensus and new evidence about market efficiency had undermined the economic theory upon which *Basic* was based.[26] Halliburton also argued that the class action litigation that *Basic* had spawned was undesirable. Accordingly, it asked the Court to overrule *Basic*.

The Supreme Court disagreed. The Court explained that the petitioner had overstated the degree to which the *Basic* decision relied on strong claims of market efficiency. Instead, the Court stated that the presumption of reliance rested on the "modest premise" that "public information generally affects stock prices."[27] The Court thereby reasoned that the modern debate about the "degree" to which prices accurately reflect public information is "largely beside the point."[28] Similarly, the Court reaffirmed *Basic*'s determination that most investors rely on a security's market price "as an unbiased assessment of the security's value in light of all public information."[29] Reasoning that *Basic*'s presumption of reliance, as a substantive doctrine of federal securities law, was entitled to stare decisis principles, the Court concluded that it was inappropriate to overrule *Basic*.

Because *Halliburton II* relied primarily on principles of stare decisis, the Court did not revisit the policy considerations that had motivated the *Basic* decision. Under an alternative approach, those policy considerations provide an independent justification for adhering to FOTM. As noted above, a key feature of private securities fraud litigation, and the class action in particular, is the fact that it is the product of a collaborative lawmaking partnership between Congress and the Court. This collaboration is entitled to special weight in evaluating legal questions that bear on the continued viability of securities fraud class actions.

As explained above, the Court and Congress both contributed to the development of the private right of action for federal securities fraud. The Supreme Court accepted FOTM in *Basic* to enable securities fraud class actions to conform to the commonality requirement of Rule 23 of the Federal Rules of Civil Procedure. The *Basic* Court explained: "Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones."[30] The Court went on to note with approval the District Court's conclusion that FOTM offered "a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Federal Rule of Civil Procedure] 23."[31]

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[25] Prior to Halliburton II, several cases had reached the Court that presented issues regarding the requirements for class certification in securities fraud litigation and thereby raised questions about the appropriate scope of class litigation (Fisch 2013).

[26] Brief for Petitioners, Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014) (No 13-317).

[27] Halliburton II at 2410.

[28] Ibid.

[29] Ibid at 2411, citing Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1192 (2013).

[30] Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988).

[31] Ibid (quoting District Court) (internal quotation marks omitted).

This focus was consistent with the intent of the Federal Civil Rules Advisory Committee, which drafted Rule 23 with securities fraud as a model for class litigation.[32] As the Committee recognized, the class action device was also an important tool for ensuring effective enforcement of the federal securities laws, explicitly recognizing this function in developing the rule. By accepting FOTM, *Basic* empowered private securities fraud litigation to serve as a tool for effective enforcement and created the opportunity for the development of the modern securities fraud class action.

Similarly, Congress responded in the PSLRA to concerns about abusive litigation with a range of procedural reforms expressly targeted to the class action (Fisch 1997). Section 21D(a) of the PSLRA is entitled "Private Class Actions" and introduces a range of reforms that apply exclusively to securities fraud class actions.[33] These reforms placed additional burdens on investors seeking to bring class actions, in an effort to reduce abusive litigation. By tailoring the structure of the class action rather than eliminating it, the PSLRA reflected an implicit congressional decision to retain the class action mechanism and the FOTM theory that made it possible (Black 2009). Importantly, the adoption of these reforms made little sense absent a desire to retain class actions (Langevoort 2015).

More broadly, the PSLRA can be understood as a legislative compromise in furtherance of two competing goals: reducing burdensome and potentially frivolous litigation, while preserving the ability of investors to pursue meritorious claims. Empirical evidence suggests that Congress was successful in achieving both goals. Studies show that the adoption of the PSLRA's heightened pleading standard facilitated courts' ability to dismiss weak cases (Johnson et al. 2007). A further effect is that, according to some studies, plaintiffs' lawyers screen more diligently for case quality and do not even file weak cases (Choi et al. 2009). Moreover, because of the PSLRA's discovery stay, these cases do not impose burdensome litigation costs upon defendants (Klausner et al. 2013).

At the same time, the lead plaintiff provision of the PSLRA has dramatically increased the involvement of large institutional investors in securities fraud class actions (Perino 2012). In turn, this has had the effect of increasing settlement amounts in meritorious cases and reducing the fees paid to class counsel (Choi 2005; Perino II 2012).

Congress's adoption of SLUSA reflected similar objectives and enhanced the effectiveness of the PSLRA reforms. SLUSA was adopted in response to efforts by plaintiffs to avoid the procedural requirements of the PSLRA by litigating securities fraud class actions in state court, and eliminated these efforts by preempting state court litigation. Significantly, SLUSA, by its terms, applies to "covered class actions," demonstrating both an effort to retain the class action mechanism and to ensure that this litigation takes place in federal court under the provisions of the PSLRA.[34] In addition, Congress defined the term "covered class action" explicitly to incorporate the FOTM presumption.[35]

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[32] Brief for *Amici Curiae* Civil Procedure and Securities Law Professors in Support of Respondent, Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184 (2013) (No 11-085).

[33] 15 U.S.C. § 78u-4(a) (2014).

[34] A "covered class action" is defined as a class action where "damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate." Ibid § 78bb(f)(5)(B)(i)(I).

[35] See ibid.

The foregoing process can be understood as sequential collaboration between the Court and Congress. First, the Court acted in *Basic* to identify the need for the fledgling class action mechanism to enable the cost-effective litigation of private securities fraud claims in order to ensure the litigation served as a viable means of enhancing enforcement. The SEC evaluated the role of private litigation and defended the class action to the Court and Congress as a necessary supplement to public enforcement. Congress, after observing the development of the class action mechanism, adopted various procedures to refine its operation in securities fraud cases. These adjustments offered the potential for securities fraud class actions to offer more effective deterrence by increasing case quality and limiting the potential for frivolous litigation.

The iterative adjustments to the securities fraud class action can be understood as a type of lawmaking partnership in which both the Court and Congress have recognized the objective of structuring a procedural device that facilitates effective enforcement of the disclosure obligations of the federal securities laws and affirmatively acted to further that objective. Because of Congress's role in responding to *Basic* and revising the nature of the securities fraud class action in important ways, *Basic* and its progeny are not properly understood simply as judicial interpretations of section 10(b) of the 1934 Act. In the PSLRA and SLUSA, Congress did more than acquiesce in judicial lawmaking; Congress embraced and sought to improve upon the Court's work.

This lawmaking partnership puts FOTM on a different legal footing than the standard interpretation of a federal statute. Unlike cases of legislative silence, in which multiple inferences can be drawn from Congress's failure to act, Congress has taken affirmative action by collaborating with the Court to refine the class action mechanism. Put differently, Congress has expanded upon the "building block" of *Basic*. This expansion reinforces the *Basic* decision as presumptively correct.

Importantly, this chapter reads congressional lawmaking with respect to the securities fraud class action as an implicit endorsement of *Basic*. Concedly an implicit endorsement is different from an explicit congressional statement codifying the judge made law. Indeed, in the PSLRA, Congress expressly stated that it was neither codifying nor rejecting any implied private right of action. As will be developed further later in the chapter, Congress might have a variety of reasons for failing to codify such a right of action expressly, including political constraints and a reluctance to constrain the scope of future judicial interpretation. These considerations, as will be discussed, are fundamental reasons for the use of a lawmaking partnership in preference to constraining judicial lawmaking through a more restrictive statute.

The implications of the lawmaking partnership constitute more than a reason for the Court not to overrule a prior interpretive decision, however. The collaboration reflected in the partnership context suggests that the Court should understand congressional interventions such as the PSLRA as refinements rather than rejections of its approach.

2.3 Conceptualizing the Lawmaking Partnership

Halliburton II's decision to reaffirm *Basic* is supported by the collaboration between Congress and the Court reflected in their lawmaking partnership. The use of such a lawmaking partnership is not unique to securities fraud litigation, however. Other areas in which Congress and the Court have engaged in collaborative lawmaking warrant a similar analysis. Simply put, judge made law in the form of a statutory interpretation that has been developed or reinforced through a lawmaking partnership should be viewed by the courts as presumptively correct absent clear congressional action overruling it.

A lawmaking partnership, as described in this chapter, has three distinctive features. First, the original statute must be open-textured so as to contemplate judicial lawmaking through the process of statutory interpretation. Second, Congress and the Court must engage in sequential adjustments, in each case cognizant of and responding to concerns that are raised in the other forum. Third, Congress and the Court must make these adjustments to further a common objective.

Each of these features is a necessary component of a lawmaking partnership. The first, an open-textured statute, has received considerable attention in the academic literature (Manning 2014). Commentators argue that Congress uses this type of legislation purposefully to enable a common law process (Sunstein 1989). Although this chapter does not take a normative position on whether such congressional delegations are desirable, it is reasonable to conclude that Congress chooses to use an open-textured statute in cases in which it contemplates a more expansive interpretive role for the courts. Reasons for this more expansive role might include limited congressional knowledge of the consequences of specific regulatory choices and a desire to encourage the type of evolutionary approach that characterizes common-law lawmaking (Eskridge 1989).

The second feature, sequential adjustments by both the Court and Congress, distinguishes the lawmaking partnership from mere congressional inaction. By taking affirmative steps in response to judicial lawmaking, Congress demonstrates that its failure to reject features of the judge made law is not the result of political gridlock or inattention. By definition, congressional responsiveness to the Court's interpretation reflects awareness of the Court's actions. Similarly, the responsive legislation constitutes action rather than inaction, thereby belying arguments that Congress was unable to react to an erroneous interpretation because of gridlock, other policy priorities, or inertia.

Finally, a lawmaking partnership is characterized by a common set of policy objectives. This distinguishes the lawmaking partnership as a common enterprise rather than two actors that are competing or working at cross purposes. Specifically, congressional responses to the Court's interpretation should reflect a consistency rather than a replacement of the policy objectives identified by the Court. Similarly, congressional action that seeks to correct errors in the Court's approach or to update policies that have become obsolete would not qualify.

In the context of private securities fraud litigation, the partnership structure offers distinctive lawmaking advantages. One advantage is that it enables Congress to achieve a level of political insulation with respect to its enforcement policy. Private securities fraud litigation is a political hot potato and, as a result, an area in which interest group politics is a particular concern (Levitan 2014). Corporate issuers and their executives face substantial liability risk in private litigation and incur considerable costs in both insurance and litigation defense. These defendants pressure Congress to reduce the scope of their liability risk by restricting private litigation. On the other hand, the plaintiffs' bar is a formidable political force as well. One study reports that the amount donated by lawyers, primarily plaintiffs' lawyers, to federal political candidates since 1990 is more than $1 billion (Copeland 2010). Putting aside the extent to which political donations and lobbying influence congressional policymaking, it is easier for Congress to delegate determination of the scope of private litigation to the federal judiciary, which enjoys life tenure. Judicial lawmaking also provides a mechanism to overcome the gridlock that might result from high levels of interest group engagement.

The lawmaking partnership also exploits the differential institutional competencies of courts and Congress. The evaluation of the scope and quality of private litigation is a subject that is peculiarly within the competence of the judiciary. The courts can readily observe the quality of private lawsuits and the extent to which litigation filings are correlated with serious misconduct. The courts can also determine the effect of various reforms such as a heightened pleading standard on litigation volume and case quality. At the same time, Congress has the capacity to consider evidence that the courts cannot observe. This evidence might include the effect of litigation costs on issuers' decisions to go public or to list their securities in the United States, or the effect of private enforcement on the capital markets. Thus, even with a common objective, the courts and Congress can bring distinct issues of competence to the question of how best to achieve that objective.

By delegating the development of private enforcement to the courts, Congress creates a potential check on the possibility of agency capture. The antifraud provision, like most of the federal securities laws, can be enforced by the SEC as well as private litigants. Some commentators have advocated for the elimination of private securities fraud litigation, arguing for the superiority of public enforcement (Bratton & Wachter 2011). Yet the effectiveness of public enforcement depends critically on the SEC's exercise of its enforcement authority (Langevoort 2006). An important constraint on public enforcement is the availability of resources—the SEC depends on Congress for funding, and Congress can limit enforcement activity just by pulling the purse-strings closed (Heminway 2005). In addition, the broad scope of regulation and actors subject to federal securities regulation requires the SEC to make policy choices. SEC officials and staff may make such choices for a variety of reasons—such as a desire to appeal to the media, to further personal career objectives, or to assuage congressional critics.

The courts are particularly well positioned to observe the areas in which SEC enforcement operates effectively. Although the courts cannot address deficiencies in public enforcement directly, they can identify those areas in which private enforcement is serving as a useful supplement by targeting conduct or defendants that are not the focus of the regulators (Cox 2005).

Finally, the lawmaking partnership offers a dynamic process. Common law adjudication has long been defended on the basis of its ability to operate incrementally and to evolve in response to changing circumstances (Fisch 2000). These features prevent the type of obsolescence that can occur in both congressional and agency lawmaking. In the context of financial regulation, this flexibility and responsiveness are particularly valuable because of the speed at which the market changes, creating new regulatory demands. Again, the case of federal securities fraud offers an illustration. The public capital markets have shifted, over the past 60 years, from retail to largely institutional markets in which disclosure takes place primarily through the internet, and which feature new types of traders and financial instruments. As the nature of the market changes, so do the nature of securities fraud and the scope of litigation necessary to deter such fraud effectively, as well as the costs and benefits of an enforcement regime.

A lawmaking partnership allows the different expertise and informational access of the courts and Congress to identify and respond to these developments. For example, *Basic* responded to the impersonal nature of the public capital markets by recognizing the difficulty for investors of proving reliance directly. The PSLRA responded to the emergence of institutional investors by harnessing their larger stakes and greater sophistication in the form of the lead plaintiff as a way of controlling litigation decisions. SLUSA responded to an effort by the plaintiffs' bar to shift litigation into state courts in order to avoid provisions such as the discovery stay.

3. THE LAWMAKING PARTNERSHIP AND INSIDER TRADING

3.1 Congressional and Judicial Development of Insider Trading Regulation

The analysis in this chapter is applicable beyond federal securities fraud. Although consideration of the lawmaking partnership in the context of other statutory schemes is beyond the scope of this chapter, securities regulation alone offers numerous instances in which the collaborative interplay of congressional and judicial lawmaking suggests that the Court should apply a more flexible and goal-oriented approach to interpreting the applicable statute.[36] Within federal securities fraud, evidence of a lawmaking partnership might inform the Court's analysis of a variety of issues.[37]

One such issue is insider trading. Federal insider trading liability is based on section 10(b), the same general antifraud provision that provides the basis for private securities fraud litigation discussed earlier in this chapter. The statute itself contains no reference to insider trading or nonpublic information (Brachman 2013). Instead, insider trading liability has been developed through the joint actions of the Court and Congress.

In *Chiarella v. United States*, the Court first accepted the premise that trading on material inside information could constitute securities fraud.[38] The Court's holding was restrictive, however; it concluded that insider trading liability required a breach of fiduciary duty. Importantly, the Court observed that its decision was not grounded in the statutory text or a finding of congressional intent, noting that "neither the legislative history nor the statute itself affords specific guidance" as to the circumstances in which "silence may constitute a manipulative or deceptive device."[39]

Chiarella did not address situations in which insiders, rather than trading themselves, disclose inside information to others who subsequently trade. In 1983, the Court addressed this so-called "tipping" in *Dirks v. SEC*.[40] Importantly, *Dirks* reinforced the Court's holding in *Chiarella* that insider trading required a predicate breach of fiduciary duty and concluded that tippees could only be liable if the tipper breached a fiduciary duty in disclosing the inside information and if the tippee knew of the breach. *Dirks*

[36] Similarly, the courts should consider the existence of a partnership in evaluating the legitimacy of agency rulemaking. Fisch (2013 II).

[37] *See* Fisch (2016) (identifying other issues to which the lawmaking partnership may be applicable and the implications of applying that approach).

[38] 445 U.S. 222 (1980).

[39] Ibid at 226.

[40] 463 U.S. 646 (1983).

further explained that a tipper breached his or her duty by receiving a personal benefit in exchange for the tip or if he or she intended to bestow a gift on the recipient.[41]

Many commentators were dissatisfied with the limitations on insider trading liability imposed by the *Chiarella* and *Dirks* decisions (Phillips & Lavoie 1988). Commentators also raised objections to the regulatory ambiguity (Painter et al. 1998). As Senator Alfonse D'Amato observed: "the present state of uncertainty about the law is simply not acceptable."[42] Between 1986 and 1988, Congress held four separate sets of hearings devoted specifically to insider trading regulation (Joo 2007).

In 1984, Congress adopted its first response to the *Chiarella* and *Dirks* decisions. The Insider Trading Sanctions Act of 1984 did not revise the judicial approach to insider trading liability or expand the scope of the prohibition but merely made minor modifications to insider trading liability, including a prohibition on the trading of options and other derivatives in circumstances in which it would be illegal to trade stock and a provision providing for treble damages.[43] The statute suggested that Congress was aware of the scope of insider trading liability reflected in the *Dirks* and *Chiarella* decisions and chose not to alter it. Despite the urging of several witnesses, Congress did not adopt a formal definition of insider trading in the statute (Painter et al. 1998).

In 1987, in response to a request from the Senate Securities Subcommittee, the SEC drafted proposed legislation that would have provided a definition of insider trading and modified several aspects of the Supreme Court's decisions (Macey 1988). A specific issue that had divided lower courts was the extent to which insider trading liability could be premised on an alternative theory: the misappropriation theory (Weiss 1998). The SEC's draft legislation sought to codify the misappropriation theory and to specify the circumstances and relationships that might give rise to a predicate duty (Macey 1988). Instead, in the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), Congress increased the penalties for insider trading and also added a private remedy for contemporaneous traders.[44]

Notably, however, Congress did not codify the misappropriation theory, which was enjoying general acceptance in the lower courts. Rather, the ITSFEA contained explicit findings that the SEC's rules regarding insider trading were "necessary and appropriate," and that it had "enforced such rules and regulations vigorously, effectively, and fairly."[45] As Steve Thel argues, these findings can be read as a congressional endorsement of the misappropriation theory (Thel 1997).

The Supreme Court finally accepted the misappropriation theory in *O'Hagan*.[46] The *O'Hagan* decision departed from the narrow approach to insider trading liability reflected in *Chiarella* and *Dirks*, relying instead on policy considerations to support its characterization of misappropriation as informational fraud. As Justice Ginsberg explained,

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41 Ibid at 663–64.

42 133 Cong. Rec. S16,393 (daily ed. June 17, 1987) (statement of Sen. Alfonse D'Amato).

43 Insider Trading Sanctions Act of 1984, 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff (2014).

44 Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No 100-704, 102 Stat. 4677 (1988).

45 Ibid § 2.

46 United States v. O'Hagan, 521 U.S. 642 (1997). The misappropriation theory was based on language in Chief Justice Burger's dissent in Chiarella. See Chiarella v. United States, 445 U.S. 222, 243–45 (1980) (Burger, C.J., dissenting).

the misappropriation theory is "tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."[47] Although *O'Hagan* did not eliminate all confusion over the scope of insider trading liability exposure, the Court's acceptance of the misappropriation theory reduced the pressure on Congress to adopt insider trading legislation. This outcome was viewed as less than optimal by some commentators who had argued that the scope of insider trading liability should be definitively resolved through legislation (Nagy 1998).

Congress subsequently passed the Stop Trading on Congressional Knowledge Act ("STOCK Act") which prohibits members of Congress from trading on inside information.[48] Two aspects of the STOCK Act reinforce the characterization of the development of insider trading regulation as a collaborative process. First, Congress again declined to provide a statutory definition of insider trading. Second, in extending the prohibition, Congress incorporated the fiduciary duty approach reflected in the Court's decisions. Specifically, the Act provides that members of Congress owe a duty of trust and confidence to Congress, the federal government, and US citizens "solely for purposes of the insider trading prohibitions."[49]

3.2 A Third Partner—The SEC

The example of insider trading introduces an additional dynamic into the lawmaking process—the SEC.[50] The SEC's initial role in developing insider trading law took the form of bringing enforcement actions that were, in some cases, supplemented by Department of Justice criminal prosecutions. It was the SEC—not Congress or the courts—that made the initial decision to use the general antifraud provision as a basis for imposing insider trading liability.[51] Subsequently, the SEC's enforcement actions have repeatedly tested the boundaries of existing law and offered new theories of liability (Park 2012).

The SEC also responded to restrictive judicial decisions through formal rulemaking. For example, the SEC responded to the narrow scope of the *Chiarella* decision by promulgating Rule 14e-3, which prohibits insider trading in connection with a tender offer and does not require a fiduciary duty.[52] The SEC responded to the information asymmetries authorized by the *Dirks* decision by adopting Regulation FD.[53] The SEC also codified its expansive approach to Rule 10b-5 by promulgating Rules 10b5-1 and 10b5-2.[54]

Including the SEC in the lawmaking partnership adds an additional dimension to the lawmaking process. In many cases, Congress and the Court have embraced the SEC's lawmaking initiatives, agreeing that the SEC's approach furthered their common policy

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47 Ibid at 658.
48 Stop Trading on Congressional Knowledge Act of 2012 ("STOCK Act"), Pub. L. No 112-105, 126 Stat. 291 (2012).
49 Ibid § 4(g)(1).
50 Commentators have devoted considerable energy to debating the appropriate extent to which Congress should delegate lawmaking authority to federal agencies. (Lemos 2010).
51 *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).
52 17 C.F.R. § 240.14e-3 (2015).
53 17 C.F.R. § 243.100 (2015).
54 17 C.F.R. §§ 240.10b5-1 & 10b5-2 (2015).

objectives. Thus, for example, Congress explicitly found, in section 2 of the ITSFEA, that the SEC's rules and regulations governing insider trading were "necessary and appropriate," and that the Commission had "enforced such rules and regulations vigorously, effectively, and fairly."[55] Similarly in *O'Hagan*, the Court both accepted the misappropriation theory proffered by the government as encompassing the necessary deception required by its earlier decisions and upheld the SEC's adoption of Rule 14e-3.[56]

In other cases, however, the Court has restrained the SEC's enforcement zeal. As noted above, even as the Court accepted insider trading liability in *Chiarella*, and extended that liability to tippees in *Dirks*, it held that the SEC's desired scope of liability was too broad. In particular, the Court rejected the SEC's desired parity-of-information standard. Similarly, in *Dirks*, the Court insisted that tippee liability be premised both upon a breach of fiduciary duty and the tippee's awareness of that breach, finding support for this approach in the scienter requirement.

Recent enforcements by the SEC have raised similar concerns in the lower courts. Mark Cuban fought a five-year battle with the SEC and won, along the way raising concerns about the validity of Rule 10b5-2 that the court took seriously (Isidore & Wallace 2013).[57] In *United States v. Newman*, the Second Circuit overturned the convictions of two hedge fund managers, third- and fourth-degree "remote tippees," suggesting the SEC's prosecution theory stretched beyond the limits established by *Dirks*.[58]

4. IMPLICATIONS OF THE PARTNERSHIP APPROACH

As the foregoing analysis explains, insider trading law is the product of a lawmaking partnership. Insider trading liability is premised on section 10(b), an open-textured statute, and the Court, Congress, and the SEC have made multiple adjustments and refinements to insider trading regulation. In each case, these adjustments have been cognizant of and responsive to the efforts of other lawmaking partners. Finally, as with private securities fraud litigation, the lawmaking enterprise seeks to appear to share the common objectives of addressing information disparities in the securities markets and maintaining public confidence while providing sufficient limiting principles to allow the information flow necessary to preserve healthy and efficient markets.

Insider trading also demonstrates the advantages of the lawmaking partnership in developing financial regulation. Congress and the SEC, to some degree, have been responsive to politically based concerns such as the public demand for greater enforcement penalties in the wake of Wall Street scandals. The Court, with its greater degree of political insulation, is able to provide a constraint on excess enforcement zeal, balancing these demands with concerns over predictability, information flow, and market efficiency. Judicial oversight can also check headline-driven lawmaking agendas, pushing the SEC in particular to justify its regulatory choices. Thus, for example, the Court's decision in *Dirks*

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[55] Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No 100-704, §2, 102 Stat. 4677, 4677 (1988).

[56] United States v. O'Hagan, 521 U.S. 642, 655 (1997).

[57] SEC v. Cuban, 634 F. Supp. 2d 713, 730–31 (N.D. Tex. 2009).

[58] United States v. Newman, 773 F.3d 438, 443 (2d Cir. 2014).

led the SEC to focus its efforts on reducing information asymmetries on issuer disclosure rather than recipient use of material nonpublic information through the adoption of Regulation FD. The Second Circuit's decision in *Newman* may similarly encourage the SEC to direct greater attention to tippers/sources rather than remote tippees. Congress also weighed in to readjust the SEC's enforcement priorities with the adoption of the STOCK Act. Notably, prior to the legislation, no member of Congress had been the subject of an insider trading enforcement action, despite evidence suggesting widespread use of material nonpublic information (Brick 2013).

Finally, the lawmaking partnership is well positioned to respond to the dynamic structure of the securities markets and the evolution of information flow due to changes in technology and market participants. Since the *Chiarella* decision, the markets have seen the emergence of many new types of traders and trading strategies—hedge funds, high-frequency traders, algorithmic trading, and index funds are all examples. Competition has led to new demands for information, which are met by innovations such as web crawlers, expert network firms, electronic road shows, and more.

These developments offer new challenges—both in defining material nonpublic information and in identifying the manners of acquiring that information that should be characterized as improper. While the financial incentives for acquiring an informational advantage are higher than ever, the value of maintaining a rich information environment offers reasons to be cautious about expansive liability provisions. A lawmaking partnership is well suited to maintaining the necessary balance.

These insights are of particular value in the aftermath of the *Newman* decision. *Newman* renewed the long dormant efforts to have Congress adopt a definition of insider trading (Henning 2015). Properly understanding insider trading regulation as the product of a lawmaking partnership, however, rebuts that claim and demonstrates that judicial oversight has provided a valuable counterbalance to regulatory excess while retaining flexibility to address market innovation. As former-SEC Chair Mary Jo White explained: "I think it's challenging to codify [insider trading law] clearly in a way that is both not too broad and retains the strength of common law."[59]

Moreover, the iterative process of adjudicative lawmaking itself offers the opportunity to reconsider and refine the scope of *Newman*, as illustrated by the Supreme Court's subsequent decision in *Salman v. United States*.[60] *Salman* reaffirmed the personal benefit requirement of *Dirks* but rejected a narrow interpretation of that requirement, holding that a tipper need not receive "something of a 'pecuniary or similar nature' in exchange for a gift to family or friends."[61] Critically, this rationale highlighted the fact that tips of inside information in the family context are distinctive, in that a tipper may receive a personal benefit simply as the result of making a gift of inside information to a close friend or family member (Fisch 2016 II).

As a result, the *Salman* decision reinforced the fact that gifting inside information to family members is illegal, without undermining the concern reflected in *Dirks* that unduly

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[59] Ben Conarck, *SEC's White Says Agency Mulled Insider Trading Ban*, LAW360 (Mar. 24, 2015, 6:58 PM), www.law360.com/articles/635363/sec-s-white-says-agency-mulled-insider-trading-ban (quoting then-SEC Chair Mary Jo White).

[60] 137 S. Ct. 420 (2016).

[61] Id. at 428 (citing *Newman*).

expansive insider trading liability poses a threat to legitimate research and the market efficiency that results from that research (Perino 2014; Fisch 2016 II). The flexibility provided to the Court by the lawmaking partnership enabled it, in *Salman*, to structure a decision faithful to both these concerns. In playing this role, the Court demonstrated its continued fidelity to Congress's objectives in developing the law of insider trading.

5. CONCLUSION

A variety of structural and political pressures constrain the effectiveness of the lawmaking process with respect to financial regulation (Levitan 2014). The lawmaking partnership offers one possible response. Through a judicial–congressional collaboration, the lawmaking partnership enables the courts and Congress to temper their own institutional shortcomings. This has led, in the context of private securities litigation, to a balance that serves the dual objectives of investor protection and limiting the potential for litigation abuse. The structural advantages of the lawmaking partnership support both deference to this balance and a broader endorsement of the lawmaking partnership.

In the case of *Halliburton II*, the implications of this analysis suggest that the Court reached the correct result in declining to overrule *Basic*, although perhaps for the wrong reasons. More broadly, the analysis suggests that the Court should be empowered to strike an appropriate balance with respect to the scope of private litigation under section 10(b).

Evidence of a similar collaborative process should inform the Court's analysis of insider trading liability. Because Congress has embraced the Court's role in a lawmaking partnership and approved of the Court's choice of regulatory objectives, the Court should view that participation as authorization to engage in its own policy analysis in furtherance of those objectives. Judicial lawmaking in this context should be understood not as unprincipled activism, but as consistent with a congressional choice of a lawmaking approach that offers distinctive advantages.

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