Duke Law Journal

VOLUME 61 DECEMBER 2011 NUMBER 3

WHAT IS SECURITIES FRAUD?

SAMUEL W. BUELL†

ABSTRACT

As Rule 10b-5 approaches the age of seventy, deep familiarity with this supremely potent and consequential provision of American administrative law has obscured its lack of clear conceptual content. The rule, as written, interpreted, and enforced, is missing a fully developed connection to—of all things—fraud. Fraud is difficult to define. Several approaches are plausible. But the law of securities fraud, and much of the commentary about that body of law, has neither attempted such a definition nor acknowledged its necessity to the coherence and effectiveness of the doctrine.

Securities fraud's lack of mooring in a fully developed concept of fraud produces at least three costs: public and private actions are not brought on behalf of clearly specified regulatory objectives; the line between civil and criminal liability has become unacceptably blurred; and the law has come to provide at best a weak means of resolving vital public questions about wrongdoing in financial markets. The agenda of this Article is threefold. First, this Article illuminates and clarifies the relationship between securities fraud and fraud and structures a discussion of legal reform that more explicitly connects

† Professor of Law, Duke University School of Law. I am grateful for the helpful questions and comments of Tom Baker, Sara Sun Beale, Stuart Benjamin, Ben Depoorter, Lisa Kern Griffin, Kim Krawiec, Dan Markel, James Park, and participants in workshops at Duke University School of Law, Willamette University College of Law, Notre Dame Law School, and Florida State University College of Law. Many thanks to Calvin Winder for research assistance of true excellence.

securities fraud remedies with the purposes of a regime of securities regulation. Second, it clarifies the line between civil and criminal liability. And third, this Article seeks a better understanding of what is being asked when legal actors and the public wonder whether to label an important instance of market failure "fraud."

TABLE OF CONTENTS

INTRODUCTION

The Securities and Exchange Commission (SEC) recently leveled a highly publicized enforcement action against the venerable investment banking and securities firm, Goldman Sachs. When the suit was filed, the headlines blared, "U.S. Charges Goldman Sachs with Fraud."[1] The theory of the case was that Goldman had sold a German bank a derivative product tied to the fate of a basket of mortgage-backed securities, while simultaneously obscuring the weaknesses of the securities in that basket. According to the SEC, Goldman obfuscated the matter by touting the role of a reputable independent firm in the selection of the underlying securities and by failing to disclose that a player who was betting against the securities was also allowed to participate in the selection process.[2]

A lively public discussion followed about whether Goldman, widely tagged as a symbol of bubble-era greed, was also crooked. Did the Goldman bankers deserve condemnation for purposely exploiting the naïveté of investors, so they could profit from the sale of products that were bets on a market Goldman knew was bound to crash?[3] Although the transaction involved in the SEC's lawsuit was small by Goldman's standards, its structure implicated big questions about the culpability of global banks for inflating a market in mortgage-derived securities that was practically designed to self-destruct.[4]

---

1. *E.g.*, Francesco Guerrera & Henny Sender, *Goldman Sachs Splash*, FIN. TIMES, Apr. 17, 2010, at 1; Louise Story & Gretchen Morgenson, *S.E.C. Accuses Goldman of Fraud in Housing Deal*, N.Y. TIMES, Apr. 17, 2010, at A1; Gregory Zuckerman, Susanne Craig & Serena Ng, *U.S. Charges Goldman Sachs with Fraud*, WALL ST. J., Apr. 17, 2010, at A1.

2. Complaint at 7–11, SEC v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010).

3. *See, e.g.*, Editorial, *After Goldman*, N.Y. TIMES, Apr. 22, 2010, at A28 (characterizing Goldman's conduct as gambling on the market); Paul Krugman, Op-Ed., *Looters in Loafers*, N.Y. TIMES, Apr. 19, 2010, at A23 ("[N]ow the S.E.C. is charging that Goldman created and marketed securities that were deliberately designed to fail, so that an important client could make money off that failure. That's what I would call looting."); John Carney, *Goldman Sachs Girds for Battle with the SEC over Fraud Case*, CNBC.COM (May 26, 2010, 4:00 PM ET), http://www.cnbc.com/id/37362236/Goldman_Sachs_Girds_for_Battle_With_the_SEC_Over_Fraud_Case ("A sticking point for Goldman is the SEC's fraud allegations. The company is unwilling to agree to any settlement that would have the appearance of affirming that Goldman committed fraud, a person familiar with the matter says. However, Goldman might be willing to settle a case alleging that Goldman was only negligent in omitting a material fact in marketing the deal, the person said."); Abigail Field, *Deconstructing Goldman Sachs's Fraud Defense*, DAILY FIN. (Apr. 19, 2010, 1:45 PM), http://www.dailyfinance.com/story/investing/deconstructing-goldman-sachss-fraud-defense/19444284 (evaluating the merits of the SEC's complaint and Goldman's defense); Tom Granahan, *In Defense of Goldman Sachs*, FOX BUS. (Apr. 21, 2010), http://www.foxbusiness.com/markets/2010/04/21/defense-goldman-sachs (questioning whether Goldman's sale of assets should really be labeled fraudulent solely because a third party believed the assets were weak).

4. Complaint, *supra* note 2, at 1. *See generally* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 6–10, 14–15 (2010) ("All these subprime lending companies were growing so rapidly, and using such goofy accounting, that they could mask the fact that they had no real earnings, just illusory, accounting-driven, ones.").

Did Goldman commit fraud? This seems like an important question to answer.[5] Indeed, given that the damages at issue in the suit were unlikely to threaten Goldman seriously,[6] this enforcement action seems to have served no greater public purpose than letting the public know whether Goldman committed fraud—thereby informing the public what such an institution is capable of and instructing other institutions and their managers about what is expected of them. But the public never got an answer to this question.

A large part of the explanation for this lacuna lies in the procedural habits and economics of SEC enforcement actions. As did the Goldman case, these actions almost all settle without a trial, and almost always with the alleged perpetrator of fraud "neither admit[ting] nor deny[ing]" the SEC's claims.[7] Because the facts of the Goldman case were never developed with any granularity—and because Goldman admitted nothing—the great case of "U.S. Charges Goldman Sachs with Fraud" simply evaporated, leaving hardly a trace beyond the $550 million fine that swelled the SEC's coffers.[8]

---

5. Debate about the nature of Goldman's responsibility for the cataclysm that stemmed from the mortgage-related securities market rages on. *See, e.g.*, WILLIAM D. COHAN, MONEY AND POWER: HOW GOLDMAN SACHS CAME TO RULE THE WORLD 1–24 (2011) ("There is little doubt that Goldman's dual decisions to establish 'the big short' and then to write down the value of its mortgage portfolio exacerbated the misery at other firms."); Louis Story & Gretchen Morgenson, *S.E.C. Case Stands Out Because It Stands Alone*, N.Y. TIMES, May 31, 2011, at A1 ("How Mr. Tourre alone came to be the face of mortgage-securities fraud has raised questions among former prosecutors and Congressional officials about how aggressive and thorough the government's investigations have been into Wall Street's role in the mortgage crisis."); Matt Taibbi, *The People v. Goldman Sachs*, ROLLING STONE, May 26, 2011, at 41 ("[T]he mountain of evidence collected against Goldman by . . . investigators—details of gross, baldfaced fraud delivered up in such quantities as to almost serve as a kind of sarcastic challenge to the curiously impassive Justice Department—stands as the most important symbol of Wall Street's aristocratic impunity and prosecutorial immunity produced since the crash of 2008.").

6. Goldman's reported revenues for 2010 were $39.16 billion. Press Release, Goldman Sachs Grp., Inc., Goldman Sachs Reports Earnings per Common Share of $13.18 for 2010, at 1 (Jan. 19, 2011), *available at* http://www2.goldmansachs.com/media-relations/press-releases/current/pdfs/2010-q4-earnings.pdf.

7. Samuel W. Buell, *Potentially Perverse Effects of Corporate Civil Liability*, *in* PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 87, 89 (Anthony S. Barkow & Rachel E. Barkow eds., 2011). I will not repeat here my complaints about the deficit of this process.

8. Consent of Defendant Goldman, Sachs & Co. at 1–2, SEC v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y. July 14, 2010) (stating, "[w]ithout admitting or denying the allegations of the complaint," that Goldman "regret[ted]" making incomplete disclosures in its marketing materials); Sewell Chan & Louise Story, *Goldman Pays $550 Million To Settle Fraud Case*, N.Y. TIMES, July 15, 2010, at A1; Press Release, SEC, Goldman Sachs To Pay Record $550 Million To Settle SEC Charges Related to Subprime Market CDO (July 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-123.htm.

But the reason that the question of fraud in the Goldman case went unanswered goes much deeper. Even if the case had been tried to a verdict, a clear answer still might not have emerged. This uncertainty is the fault not of the SEC but of the law of securities fraud, which does not require the question of whether fraud was committed to be asked in the first place.

The law allows a case like the one against Goldman to be alleged and argued as securities fraud even if the seller merely failed to exercise due care as to whether the buyer was misled about the nature of the securities being sold or how those securities were selected.[9] The law further permits a claim of fraud—even when brought by a private litigant—to be founded on an allegation of recklessness and allows the litigant to assert, in essence, gross negligence as to whether the buyer was misled. If one takes the federal appellate decisions on the issue at face value, the law would appear to support a *criminal conviction* in a case like Goldman's even if the seller were merely reckless.[10] Finally, the law leaves unsettled questions about when and how special relationships can render certain conduct fraudulent that would not be so in other contexts.[11]

Doctrinally, the problem includes opacity on questions of duty and fuzziness—as well as excessive permissiveness—with respect to rules of fault. These doctrinal failings, in turn, connect to the deeper question of whether the law of securities fraud is necessarily tethered to the concept of fraud.

If one believes that fraud is a morally charged concept that requires that an actor seek to deceive another, then two commitments follow. First, no such thing as no-fault fraud, negligent fraud, or arguably even reckless fraud can exist. And second, any liability inquiry must consider both the actor's degree of fault with respect to the falsity of her representation or the tendency of her conduct to mislead *and* her objective in making the relevant representation or

9. *See infra* text accompanying notes 120–41. Though it is not a securities fraud case, the Department of Justice's (DOJ's) pending civil case under the False Claims Act, 31 U.S.C. §§ 3729–3733 (2006), against Deutsche Bank related to the collapse of the mortgage market—an enforcement action that likewise fetched substantial headlines—raises the same concerns. The complaint is full of allegations that Deutsche Bank repeatedly lied about what it was doing in the mortgage market, but the legal theories are based on claims of negligence and gross negligence. Complaint at 1, 40–47, United States v. Deutsche Bank AG, No. 11 Civ. 2976 (S.D.N.Y. May 8, 2011).

10. *See infra* text accompanying notes 154–74.

11. *See infra* text accompanying notes 117–19.

engaging in the relevant conduct. According to this way of thinking, fraud is a particular instance of wrongdoing, like murder or slander, for which a particular kind of responsibility attaches to the transgressor.

If, however, one believes that fraud is a victim-centered concept having to do with harm suffered at the hands of an actor whose words or conduct misled another, then fewer commitments follow. Fraud may be based on negligent statements or conduct, or perhaps even on duly careful but nonetheless harmful statements or conduct. No inquiry into an actor's intentions is required. According to this line of thought, fraud is more like a category of legal actions, such as homicide or property-related torts. Liability may be triggered without necessarily imputing moral responsibility.

Many bodies of law have proceeded down one or the other of these paths in dealing with the ancient legal idea of fraud.[12] But the law of securities fraud has tried to have it both ways.

This field of law speaks and acts as if it endorses the first view. It deploys not only private remedies but also public sanctions of both a civil and a criminal nature, including fines, imprisonment, and forms of debarment.[13] Furthermore, the legislative and administrative history and judicial interpretations of securities fraud provisions, as well as the rhetoric of public officials who enforce the securities laws, assert that the law of securities fraud polices cheating and venality in markets.[14]

At the same time, the statutes, rules, and doctrine of securities fraud endorse the second view of fraud. They permit virtually all of the available sanctions to be levied based on negligent or, at most, tortiously reckless conduct. They at times require intent, but dilute its meaning to such an extent that it is no longer recognizable. And they

12. *Compare, e.g.*, United States v. Diggs, 613 F.2d 988, 997 (D.C. Cir. 1979) (stating that "proof of fraudulent intent is critical" in criminal prosecutions for mail fraud), *with, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 164 (1981) (providing that misstatement-inducing assent voids a contract if it is either fraudulent or material).

13. *See* Securities Exchange Act of 1934 §§ 21B, 32, 15 U.S.C. §§ 78u-2, 78ff (2006) (setting forth the civil and criminal penalties for SEC violations); Dearlove v. SEC, 573 F.3d 801, 837 (D.C. Cir. 2009) (holding that an accountant's unreasonable conduct during an audit of financial statements warranted debarment from SEC practice).

14. *See, e.g.*, Chem. Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984) (Friendly, J.) (identifying the purpose of securities regulation as preventing deception and trickery); *Recent Press Releases*, SEC, http://www.sec.gov/news/press.shtml (last modified Nov. 10, 2011) (announcing various prosecutions brought by the SEC against people who had gained an unfair advantage in the market through deception or insider knowledge).

cling jealously to a vague genesis story about securities fraud's origins in common-law fraud—a story that connects to both law and equity jurisdiction and that represents perhaps the most flexible and permissive account of the legal idea of fraud.

This duality and, at times, incoherence about the purpose and essence of the law of securities fraud undermines the public interest in at least three ways. First, a massive sanctioning machinery is mobilized without any commitment from the legal system about which among three possible aims that apparatus is meant to serve: forcing disclosure, improving accuracy in disclosure, or deterring lying and cheating. How can an observer know whether a liability system is producing anything approaching optimal outcomes when the system has not identified the objectives against which to measure outcomes?[15] Surprisingly, the leading contemporary literature on securities fraud focuses heavily on outcome optimality—chiefly, from empirical and institutional-design perspectives—without exploring the question of what securities fraud *is*.[16]

Second, the law of securities fraud does not conduct the inquiry that the public debate about financial wrongdoing appears to demand. When the body politic fulminates over a case like Goldman's, it may be solely concerned with harm and loss: "Curse those greedy bankers. They ought to be made to pay when the little

15. *See* Joseph Raz, *Responsibility and the Negligence Standard* 15–16 (Columbia Law Sch. Pub. Law & Legal Theory Working Paper Grp., Paper No. 09-207, 2009), *available at* http://ssrn.com/abstract=1436022 (arguing that efficiency cannot be measured without first settling normative questions).

16. *See, e.g.*, Lynn Bai, James D. Cox & Randall S. Thomas, *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. PA. L. REV. 1877, 1912–14 (2010) (studying the effects of class action settlements on the operating efficiency of firms); Stephen J. Choi, Karen K. Nelson & A.C. Pritchard, *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. EMPIRICAL LEGAL STUD. 35, 35–37 (2009) (considering whether the Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.), successfully screens frivolous claims); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1538 (2006) (arguing that to deter securities fraud most effectively, significant financial damages should be imposed on the culpable actors, not, for example, on innocent shareholders); Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176 (2010) (suggesting that the power to enforce the securities fraud provisions be consolidated in the SEC).

guy suffers from their craven profligacy."[17] Such sentiment is present in the discussion, to be sure.[18]

But people are also up in arms over whether the big guys did something more grievous than making a bumbling hash of the markets at the public's expense. When the government introduces the idea of fraud into the discussion, the public wants to know whether there was something like purposeful deception on Goldman's part. Such a culpable purpose was strongly implied in the SEC's condemnatory recitation of the facts in its complaint against Goldman. But it was not a purpose to which the SEC had to commit as a matter of pleading, nor would the SEC have been required to prove it to secure a jury verdict or an appellate victory.

One could take the position that political discourse about wrongdoing in financial markets is an entirely separate matter from the law of securities fraud and the professionalized processes of its enforcement and adjudication. But that would require ignoring evidence that messages, perception, and individual cases have a significant influence on the behavior of managers[19] and forgetting the mantra that maintenance of elusive "investor confidence" is a prime function of regulation in this context.[20]

Securities fraud is probably underenforced, even if it may be oversanctioned in some cases. Because enforcement resources are

---

17. Of course, only systemically speaking were "little guys" victimized in the Goldman case. In the transaction itself, the allegedly defrauded buyer was no little guy.

18. Even relatively informed participants in the public discussion can display tendencies in this direction. *See, e.g.*, Andrew Ross Sorkin, *Pulling Back the Curtain on Inquiries*, N.Y. TIMES, Dec. 7, 2010, at B1 (speculating on why the Obama Justice Department has pursued small fraudsters in large numbers but has left the leaders of large firms largely unmolested in recent criminal inquiries, but failing to consider the possibility that prosecutors may lack sufficient evidence of criminal guilt to prove such cases). For a taste of the large dollop of which I speak, one need only peruse the online comments posted in response to a column such as Sorkin's. *See Readers' Comments: Pulling Back the Curtain on Fraud Inquiries*, N.Y. TIMES, http://community.nytimes.com/comments/dealbook.nytimes.com/2010/12/06/pulling-back-the-curtain-on-fraud-inquiries/?sort=oldest (last visited Nov. 9, 2011). Another such source is Charles Ferguson's Oscar-winning film, INSIDE JOB (Sony Pictures Classics 2010).

19. *See* Jodi L. Short & Michael W. Toffel, *Making Self-Regulation More Than Merely Symbolic: The Critical Role of the Legal Environment*, 55 ADMIN. SCI. Q. 361, 361 (2010) ("We find that organizations are more likely to follow through on their commitments to self-regulate when they (and their competitors) are subject to heavy regulatory surveillance and when they adopt self-regulation in the absence of an explicit threat of sanctions.").

20. *See, e.g.*, SEC v. Zandford, 535 U.S. 813, 819 (2002) ("Among Congress' objectives in passing the Act was 'to insure honest securities markets and thereby promote investor confidence' after the market crash of 1929." (quoting United States v. O'Hagan, 521 U.S. 642, 658 (1997))).

limited, public awareness of enforcement is at least as important as the price that enforcement imposes. When the law of securities fraud fails to generate juridical processes that instruct the public on who deserves blame and why, it wastes a valuable resource.

Third, as a regime imposing civil and criminal liability, the law of securities fraud is obligated by principles of legality and fairness—not to mention efficiency—to choose one of two positions. Either the law of securities fraud endorses a near complete overlap between civil and criminal liability, making criminal sanctions available for any form of compensable conduct—in which case it would be an anomaly among Anglo-American legal regimes—or, more plausibly, it reserves criminal sanctions for serious forms of wrongdoing—in which case it would need to specify the conditions of fault and harm that make imprisonment and other forms of criminal punishment available. The law of securities fraud's failure to commit to a theory of fraud is at the root of its failure to be clear about what conduct triggers criminal liability.

The motivation for this Article is the belief that illuminating the relationship between securities fraud and the concept of fraud can ameliorate the three problems just described, all of which are located in both the law of securities fraud and the public discourse about market-based fraud. Some theoretical backfilling is required to stabilize this potent but aging body of law. After this groundwork is laid, one can see a compelling case for several accessible reforms: redrafting the statutes and rules governing securities fraud to distinguish causes of action for core fraud from those for misrepresentation and to differentiate claims of criminal fault from those of civil liability; and, in the absence of such rewriting, improving judicial decisions in the field of securities fraud to clarify those same distinctions.

In Part I, I explore options for defining the concept of fraud and identify the choices one makes when selecting among those options, with a particular focus on the crucial role of mental state in fraud. In Part II, I detail the causes of action available under Rule 10b-5[21] and related provisions and compare them to conceptions of fraud, concluding that the idea of securities fraud remains undefined. In Part III, I identify the normative stakes of failing to clarify and strengthen the connection between fraud and securities fraud. I also suggest

21. 17 C.F.R. § 240.10b-5 (2011).

avenues for reforming the law and improving public discourse about fraud in financial markets.

I. WHAT IS FRAUD?

To examine the relationship between securities fraud and fraud, it is necessary to start with the concept of fraud. In this Part, I begin by explaining why fraud, like many ambitious legal concepts, is difficult to nail down. Fortunately, a complete understanding of the concept is not required here. To understand the law of securities fraud, one need only understand several axes along which one might define fraud. I begin this Part by setting forth those axes. I then turn to explaining the role of mental state in fraud, as mental state is the primary vehicle by which legal doctrine animates a particular conception of fraud. Then, in Part II, I demonstrate how the law of securities fraud relies on multiple, conflicting, and incomplete conceptions of fraud.

A. The Question Is Hard and Important

How should one define the sociolegal concept of fraud? This question is hard because, as I explore elsewhere in greater detail, fraud is a legal concept designed to adapt alongside the evolving behaviors that it targets.[22] Fraud can have fixed meaning only at a very general level. If one attempts to key one's definition of fraud to descriptions of behaviors, new behaviors will inevitably be invented, or will simply arise, that expose the definition as faulty and underinclusive. This need for flexibility in the definition of fraud arises because fraud involves a category of human wrongdoing that is characterized by inventiveness and that is often situated within realms of economics, technology, and industry that are sites of rapid social and economic development.

The social realities of fraud thus exert great pressure on legal regimes to address fraud with open-textured rules that are vulnerable to complaints of intolerable vagueness. Fraud is somewhat like

22. *See* Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. REV. 1971, 1972 (2006) ("Instability in the law of fraud is structural."). Many judicial formulations of this idea exist, and they can be found going back several centuries. A perhaps extreme, but not atypical, version is the following: "Fraud is kaleidoscopic, infinite. Fraud being infinite and taking on protean form at will, were courts to cramp themselves by defining it with a hard and fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition." Stonemets v. Head, 154 S.W. 108, 114 (Mo. 1913).

negligence in that it is designed to be an all-encompassing concept of wrong that a common-law system of adjudication can deploy as needed and define as it goes along, addressing cases ex post. But fraud is a morally richer concept than negligence, with greater normative ambitions. Fraud is in the business of condemnation and punishment, not just compensation. As such, fraud cannot easily justify ex ante vagueness, with large gaps to be filled in terms of specific behaviors entirely ex post.

One needs a definition of fraud that strikes an acceptable balance between social demands and inexorable human advancement on the one hand and liberty interests on the other. If too restrictive a definition is adopted, one quickly runs into cases that are obviously fraud but that are not included. If too loose a definition is adopted, one has no good answer to the defendant who asserts unfair surprise at the imposition of a sanction. Erring in either direction is likely to undermine the credibility of fraud law. If the law fails to punish actions that resonate publicly as frauds, the law and its enforcers will be condemned for being toothless in the face of innovative predation. If the law does not appear to make principled distinctions or to display predictability with respect to the persons it chooses to sanction for fraud, then the project of regulating fraud will lose moral valence, ceasing to be about condemning those who deserve it and instead becoming a vehicle for parochial agendas—political, economic, or otherwise.

This difficult conceptual and definitional problem is important because fraud is employed so widely in the regulatory system and referenced so frequently in the public discourse. Fraud is among the most serious, costly, stigmatizing, and punitive forms of liability imposed on actors in modern corporations and financial markets.[23] Its reach extends across all state and federal jurisdictions, over virtually all forms of civil and criminal sanctions, and into nearly every realm of financial engineering and economic exchange. If the legal system cannot be clear on what fraud is, then policymakers and the general public are not likely to get very far in understanding what of legal

---

23. *See* Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Legal Penalties for Financial Misrepresentation 8 (May 2, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=933333 ("When criminal fraud or intent is suspected, the SEC can refer the matter to the DOJ for parallel criminal prosecution. Criminal penalties include fines and various forms of probation or incarceration . . . .").

significance has happened when something goes wrong in the markets, much less in knowing what to do about it.

A good conception of fraud therefore must satisfy three general conditions: sufficient flexibility for the law to adapt to changes in behavior by primary actors, sufficient clarity for the law to satisfy requirements of notice and guidance of discretion by legal actors, and sufficient content for the law to inform the public of the nature of the wrongdoing involved when an actor is held liable for fraud.

B. Some Axes of Fraud

Several approaches to the definitional problem are possible. A useful strategy is to consider six axes with which the concept of fraud intersects.[24] A reasonably complete and functional conception of fraud requires addressing most or all of these six axes:

(a) Act: Fraud might be limited to false representations—whether made directly or by a partial representation that is misleading due to omission. Alternatively, fraud might include instances of nondisclosure and conduct that have misleading effects. For example, one might falsely state that a product is free of any defects. Or one might fail to disclose a known defect.[25]

(b) Fault: Fraud might require a deceitful perpetrator who acts intentionally and with knowledge of the tendency of her words or conduct to mislead—perhaps ordinary knowledge, or possibly a relaxed form that relies on willful blindness or some form of recklessness. Alternatively, fraud might include instances in which an actor simply causes another to be misled—grossly negligently, negligently, or even in spite of due care. For example, a seller might set out to induce an undecided buyer to purchase her product by falsely stating that it is free of a defect. Or a seller might answer the buyer's question about whether the product is free of defect in the affirmative, without having examined the product in a manner that would have revealed a defect.

---

24. Regrettably, there being six of them, graphic representation of these axes is beyond my competence.

25. Fraud can be committed through a true statement that is misleading because it omits additional facts that are necessary to make those facts that are uttered not misleading (fraud by partial omission). RESTATEMENT (SECOND) OF TORTS § 529 (1976). Fraud can be committed by silence (fraud by complete omission or by nondisclosure). W. PAGE KEETON, DAN B. DOBBS, ROBERT E. KEETON & DAVID G. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 106, at 736–37 (5th ed. 1984). Or fraud can be committed by action rather than by utterance or representation (fraud by conduct). RESTATEMENT (SECOND) OF TORTS § 525 cmt. b.

(c) Context: Fraud might differ depending on the type of relationship in which it is committed. Actors with fiduciary and similar duties might be responsible for fraud in a greater diversity of situations and under more relaxed conditions than actors in arm's-length transactions. For example, a seller might decide to induce an undecided buyer to purchase her product by failing to disclose a known defect in an arm's-length transaction in an ordinary market. Or a seller might do the same thing in a relationship that carries greater duties of the seller and higher expectations by the buyer than in ordinary dealing.

(d) Sanction: Fraud might be a vehicle for imposing monetary sanctions only, perhaps limited to forms of tort and contract damages. Alternatively, it might be a means of effecting equitable remedies or of imposing punishment. For example, if one deliberately misrepresents the finances of a public company, one might be required to pay damages to harmed shareholders. Or one might be enjoined from managing a public company or required to serve a term of imprisonment.

(e) Harm: Fraud might require the intrusion on—or deprivation of—an economic interest of a measurable sort. Alternatively, it might extend to deprivations of other kinds of interests, like choosing whether to rely upon a particular expert versus another, or whether to engage in certain kinds of social relations with other persons. For example, one might falsely represent one's wealth to induce a person to trust one to invest that person's savings. One might falsely represent one's expertise to gain another's trust in the provision of health care. Or one might falsely represent one's wealth to induce a person to commence a romantic relationship.

(f) Sector: Fraud might be limited to private dealings of an economic nature. Alternatively, it might include conduct in the public sector involving deception by public officials vis-à-vis their constituents, or by citizens vis-à-vis government functions. For example, an officeholder might falsely represent the origin of campaign funds to induce voters to reelect her. Or a person might fabricate documents to induce the government to abandon an investigation that could implicate her in a violation of the law.

These are axes, not binary choices; a particular conception of fraud might locate itself at various points along each axis. The more a conception of fraud positions itself toward the broader, more permissive, more capacious extremes on these axes, however, the less fraud is a responsibility concept, used to identify actors who have wrongfully violated the rights of others or who have committed public wrongs. Located on these ends of the axes, fraud is more of a label for a situation in which the law compensates persons, shifts losses, or prices certain conduct.

The most expansive conception of fraud would cover conduct and omissions as well as statements; encompass all acts that mislead, including negligent and even careful ones; impose further obligations of disclosure and care on actors in special relationships; permit all forms of sanctioning, civil and criminal; extend to deprivations of noneconomic as well as economic interests; and apply to a variety of interactions between individuals and the government in the realm of public and political functions.[26]

---

26. I will not deal here with two other avenues for conceiving of fraud. The first avenue would be to explore fraud as a social construct by studying public opinion about fraud through survey and interview work, perhaps coupled with an examination of discourse about fraud in the popular media. For examples of this approach, see Paul H. Robinson, Michael T. Cahill & Daniel M. Bartels, *Competing Theories of Blackmail: An Empirical Research Critique of Criminal Law Theory*, 89 TEX. L. REV. 291, 313–22 (2010); Paul H. Robinson & John M. Darley, *Objectivist Versus Subjectivist Views of Criminality: A Study in the Role of Social Science in Criminal Law Theory*, 18 OXFORD J. LEGAL STUD. 409, 417–21 (1998); and Paul H. Robinson & John M. Darley, *Testing Competing Theories of Justification*, 76 N.C. L. REV. 1095, 1108–15 (1998). To get a sense of the debate about this methodology, see Donald Braman, Dan M. Kahan & David Hoffman, Reply, *A Core of Agreement*, 77 U. CHI. L. REV. 1655, 1655–60 (2010); Donald Braman, Dan M. Kahan & David A. Hoffman, *Some Realism About Punishment Naturalism*, 77 U. CHI. L. REV. 1531, 1532–38 (2010); and Paul H. Robinson, Owen D. Jones & Robert Kurzban, Response, *Realism, Punishment, and Reform*, 77 U. CHI. L. REV. 1611, 1611–15 (2010). The second avenue would be to describe fraud in terms of outcomes produced by actors in the legal system and the incentives that operate on those legal actors. William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 506–11, 517–19, 546–49 (2001). For example, fraud might turn out to be large financial losses caused by persons who lack sufficient power in the political economy to convince legislators and enforcers to steer sanctions away from them. *See* Vikramaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L.Q. 95, 97–98 (2004) ("Overall, my analysis suggests that most of the important players, including many corporations and management, have reasons to support some corporate crime legislation. This is because it helps to avoid or mitigate legislative and judicial alternatives—such as new forms of corporate civil liability and managerial criminal liability—that would be even more costly to corporate interests." (emphasis omitted)). Or, in a perhaps contradictory finding, fraud might be defined so as to allow sanctions against those individuals whose punishment would yield the greatest career benefits for enforcers. *See, e.g.*, Edward L. Glaeser, Daniel P. Kessler & Anne Morrison Piehl, *What Do Prosecutors Maximize? An Analysis of the Federalization of Drug Crimes*, 2 AM. L. & ECON. REV. 259, 261 (2000) (noting that prosecutors might prosecute high-profile individuals to further their own careers); Daniel C. Richman & William J. Stuntz, *Al Capone's Revenge: An Essay on the Political Economy of Pretextual Prosecution*, 105 COLUM. L. REV. 583, 607 n.78 (2005) ("There is some evidence that federal prosecutors do pursue such career goals in their case selection decisions.").

As I show in Part II, the law of securities fraud has done a poor job of coherently locating itself on these axes. In terms of its rhetoric, its purposes, and its function in the regulatory state, this body of law appears to be based on a conception of fraud as a particular and meaningful form of wrongful conduct. But in terms of its text and its doctrine, it has consistently gravitated toward the expansive end of five of the six axes. The exception is the public-private sector axis, axis (f).[27] In securities regulation, the public-private problem is not relevant: the government and its agents can be neither perpetrators nor victims of securities fraud.

Before dealing with the law of securities fraud, however, it is necessary to examine in considerable depth the matter of fault, axis (b), which both intersects all of the other axes and eclipses them in importance. Mental state, or the lack thereof, is the primary territory in which the law of fraud animates one conception of fraud or another. The significance of mental state in fraud must be understood with some precision.[28]

27. Public fraud has been a subject of intense controversy in other areas of federal fraud regulation. *See, e.g.*, McNally v. United States, 483 U.S. 350, 352–61 (1987) (reversing a mail fraud conviction because the statute did not proscribe defrauding the public of its right to an honest government); United States v. Weyhrauch, 548 F.3d 1237, 1239 (9th Cir. 2008) (holding that the federal honest-services mail fraud statute does not require that the conduct at issue also violate an applicable state law), *vacated*, 130 S. Ct. 2971 (2010); United States v. Margiotta, 688 F.2d 108, 113 (2d Cir. 1982) (affirming the conviction of a political leader for mail fraud predicated upon a breach of fiduciary duty to the community, although the political leader had held no official public office); Abraham S. Goldstein, *Conspiracy To Defraud the United States*, 68 YALE L.J. 405, 417 (1959) ("A detailed examination of the cases dealing with [the federal crime of conspiracy's requirement that a defendant] 'defraud the United States' will reveal that . . . . [t]he phrase has no fixed meaning. Instead, it has acquired a series of meanings—some supplanting prior ones, others existing concurrently." (quoting Act of Mar. 2, 1867, ch. 169, § 30, 14 Stat. 471, 484)). The question of what kinds of offender objectives and victim interests mark out the boundary of fraud is implicated in the recent controversy over the federal honest-services fraud statute, 18 U.S.C. § 1346 (2006). *See* Skilling v. United States, 130 S. Ct. 2896, 2931–34 (2010) (holding that the honest-services statute is limited to bribery and kickbacks); Samuel W. Buell, *The Court's Fraud Dud*, 6 DUKE J. CONST. L. & PUB. POL'Y 31, 31–33 (2010) (discussing the Supreme Court's failure to conceptually develop its fraud jurisprudence in three mail fraud cases from the October 2009 Term).

28. Others have criticized the state of the law establishing the mental states required to impose liability for securities fraud. *See generally* Norwood P. Beveridge, *Is* Mens Rea *Required for a Criminal Violation of the Federal Securities Laws?*, 52 BUS. LAW. 35 (1996); Elaine E. Bucklo, *The Supreme Court Attempts To Define Scienter Under Rule 10b-5:* Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977); James D. Cox, Ernst & Ernst v. Hochfelder*: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws*, 28 HASTINGS L.J. 569 (1977); Louis Haimoff, *Holmes Looks at* Hochfelder *and 10b-5*, 32 BUS. LAW. 147 (1976); Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667 (1991);

C. Mental State and Fraud

1. *Core Fraud Versus Misrepresentation.* At a general level, the centrality of mental state to any conception of fraud is easy to see. Consider the following two stylized accounts, which I will resist giving labels because each can potentially accommodate multiple schools of thought and modes of legal regulation.

Account A: Fraud is a morally wrongful act that one person does to another. It is best conceived as requiring purposeful deception. Deception is required because fraud is not robbery, theft, battery, burglary, extortion, or any number of other forms of wrongdoing that one might characterize as more core than fraud. Fraud is the indirect means of accomplishing what cannot be done directly. The idea is to cause a victim to do or to relinquish something voluntarily that the victim otherwise would not do or relinquish but for being subject to a misapprehension at the hands of the violator—as opposed to being subject to the violator's exercise of force or coercion.

Fraud is a fairly modern concept, the product of social evolution in two directions: toward greater societal recognition of an individual's entitlement to integrity of property and similar personal interests, and toward greater individual appreciation that society will not tolerate the appropriation of others' interests by violence or its equivalent. Laws and norms against the use of force and coercion begat schemes to defraud. Such schemes begat laws and norms against fraud. Antifraud law and its enforcement begat new technologies of fraud. And on it goes.[29]

In this account, purpose is necessary to the concept of fraud because the better definition of deception requires that the actor intend to deceive the other party.[30] Although some commentators

William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121 (1997); Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. CORP. L. 179 (1986); Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025; Michael L. Seigel, *Bringing Coherence to Mens Rea Analysis for Securities-Related Offenses*, 2006 WIS. L. REV. 1563; John L. Ruppert, Note, *The Supreme Court's Trimming of the Section 10(b) Tree: The Cultivation of a New Securities Law Perspective*, 3 J. CORP. L. 112 (1977). None of these works has developed a comprehensive analysis of the concepts of fraud and securities fraud as routes to rethinking and reforming the doctrine across the fields of criminal, regulatory, and private civil liability.

29. This phenomenon is discussed at greater length in Buell, *supra* note 22, at 1977–96.

30. STUART P. GREEN, LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE-COLLAR CRIME 76–79 (2006); James Edwin Mahon, *The Definition of Lying and*

have argued that deception can occur even when one unwittingly causes another to labor under a misapprehension, this view makes deception a less descriptive and meaningful term.[31] Although I have no evidence on the point, I believe that the alternative view also corresponds less well to common usage of the term.

To speak untruth is to lie. Most agree that the best definition of lying excludes the unwitting utterance of falsehoods.[32] To deceive is to do more than lie. Deception is more morally serious than lying because it involves, through words or conduct, the willed alteration of another's mental processes[33]: "'[D]eceive' is a success or an achievement verb."[34] All else being equal, a deception intrudes more seriously on the autonomy of another person than does a lie. Purpose is therefore necessary to give the concept of deception the moral content it ought to have. If fraud requires deception and deception requires purpose, then fraud requires purpose.

Of course, purposeful deception is not sufficient to define wrongful conduct as fraud. One who went around purposefully deceiving, just for the sake or pleasure of producing such states of mind, would not be called a fraudster, even if she were seen to be a pathological liar and therefore morally at fault.[35] In the case of fraud, the deception is in service of a goal. Without such a goal having formed in the mind of the actor, no fraud exists.

Account B: Fraud is a problem of costs and efficiency[36] or, at most, one of a damaged victim who is entitled to legal redress and to

---

Deception, STAN. ENCYCLOPEDIA OF PHIL. (Feb. 21, 2008), http://plato.stanford.edu/entries/lying-definition.

31. Mahon, *supra* note 30.

32. *Id.*; *see also* John Morris, *Can Computers Ever Lie?*, 14 PHIL. F. 389, 390 (1976) ("When we say that someone tells a lie, we mean at least this: that he asserts something, claiming (implicitly or explicitly) that it is true, and thereby pledging his own faith in its truth; that, in fact, he believes that it is untrue; and finally that he hopes that his listener will be deceived by what he says, and believe that it is true.").

33. *See* James Edwin Mahon, *A Definition of Deceiving*, 21 INT'L J. APPLIED PHIL. 181, 181 (2007) ("Whether or not an act of lying has occurred does not depend on whether or not a particular effect—for example, the belief that what the liar says is true—has been produced in another . . . .").

34. *Id*. at 190.

35. *See* Roderick M. Chisholm & Thomas D. Feehan, *The Intent To Deceive*, 74 J. PHIL. 143, 146–48, 159 (1977) (distinguishing between lying, which is "the endeavor to *add* to someone's stock of false beliefs," and bad faith, which is "the endeavor to *subtract* from someone's stock of true beliefs").

36. *E.g.*, Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 137–38 (1979).

be made whole.[37] The most important question is not what the relevant actor thought and did, but rather what happened to the person who lost on the exchange. Purposeful deception is not required. The actor need merely have caused a loss in a particular way: the victim suffered a loss as a result of entertaining a misapprehension due to something the actor did, expressed, or failed to express.

This conception of fraud involves something more than "costs that could have been avoided more efficiently by the actor whose conduct caused the loss." Such a definition would not distinguish fraud from a broader concept like tort. The costs must result from the victim's having been misled. Fraud is a special kind of actionable causation of loss having to do with persons suffering harm after being misled by others.[38] This legal device is justified, on this account, by welfare considerations such as the costs associated with defensive measures, market exit, and other likely behavioral responses in environments in which fraud is not sanctioned. Alternatively, justifications sounding in corrective justice have to do with interference with an individual's entitlement to make choices free of misinformation under certain circumstances.[39]

* * *

Cases akin to Account A undoubtedly constitute fraud. Although the law has sometimes used the term misrepresentation to describe cases based on Account B,[40] these cases have, on other

37. *See* John C.P. Goldberg, *The Constitutional Status of Tort Law: Due Process and the Right to a Law for the Redress of Wrongs*, 115 YALE L.J. 524, 530 (2005) ("[N]otwithstanding the dominant tendency among modern scholars to treat tort law as an instrument for attaining public goals such as loss-spreading or efficient precaution-taking, it is still best understood as a law of redress."); John C.P. Goldberg & Benjamin C. Zipursky, *Torts as Wrongs*, 88 TEX. L. REV. 917, 918 (2010) (asserting that tort law is focused on "wrongs and recourse" rather than on the allocation of accident costs).

38. Note that a view in the style of Account B need not entail limiting fraud law to civil remedies. Criminal liability, unlike under federal fraud law, could require proof of harm to a victim. Or criminal liability could attach upon proof of a conspiracy or an attempt or scheme to impose certain types of loss or gain.

39. *See* John C.P. Goldberg, Anthony J. Sebok & Benjamin C. Zipursky, *The Place of Reliance in Fraud*, 48 ARIZ. L. REV. 1001, 1011 (2006) ("[T]he core of the legal wrong that has historically been labeled 'fraud' or 'deceit' is the wrong of interfering with a particular interest of the victim, namely her interest in making certain kinds of choices in certain settings free from certain forms of misinformation.").

40. *See, e.g.*, Quail Hill, LLC v. Cnty. of Richland, 692 S.E.2d 499, 508 (S.C. 2010) (stating the elements of the common-law tort of negligent misrepresentation as "(1) the defendant made

occasions, been called fraud. Thus, I will refer to cases based in Account A as cases of core fraud.[41] Core frauds require everything needed to establish a misrepresentation, plus something more that, in general, is highly significant in law: the actor's level of mental state, fault, culpability, or moral blameworthiness.

Tort law has sometimes, but not always, distinguished misrepresentation from core fraud. One might assert that a victim can sue in tort for fraud without having to prove that the actor had a purpose to deceive or a particular goal in mind.[42] The word "fraud," however, has been called "a source of great mischief in tort law"[43] and "a term so vague that it requires definition in nearly every case."[44] In American law, the tort of fraud—which also has gone by the names deceit and misrepresentation—is an umbrella term that includes several causes of action.[45]

The Restatement (Second) of Torts defines a tort called "misrepresentation," which encompasses instances of damages incurred as a result of reliance on false information provided by others.[46] A subcategory of misrepresentation is fraudulent misrepresentation.[47] A misrepresentation is fraudulent if it is made with scienter—defined as knowledge or belief in falsity, or lack of the

---

a false representation to the plaintiff; (2) the defendant had a pecuniary interest in making the statement; (3) the defendant owed a duty of care to see that he communicated truthful information to the plaintiff; (4) the defendant breached that duty by failing to exercise due care; (5) the plaintiff justifiably relied on the representation; and (6) the plaintiff suffered a pecuniary loss as the proximate result of his reliance on the representation"); *see also* RESTATEMENT (SECOND) OF CONTRACTS §§ 159, 162 (1981) (distinguishing misrepresentation from fraud by requiring intention for fraud but not for misrepresentation).

41. *See* Goldberg et al., *supra* note 39, at 1005 ("[T]he phenomenon of *being misled* stands at the very heart of the tort action for fraud." (emphasis added)).

42. *See, e.g.*, Nielsen v. Adams, 388 N.W.2d 840, 846 (Neb. 1986) ("The fact that the defendant deceives, itself, establishes scienter even though the defendant may have been unaware of the deception. Therefore, to the extent that we have, in previous cases, included 'intent to deceive' as a necessary element of a cause of action for fraudulent misrepresentation or deceit, we specifically now reject that view . . . ."); Kincaid v. SouthTrust Bank, 221 S.W.3d 32, 39–40 (Tenn. Ct. App. 2006) ("Constructive fraud is essentially fraud without the element of intent. Neither actual dishonesty of purpose nor intent to deceive is an essential element of constructive fraud." (citation omitted)).

43. Goldberg et al., *supra* note 39, at 1003.

44. KEETON ET AL., *supra* note 25, § 105, at 727.

45. *Id*. § 105, at 726; *see also* Leon Green, *Deceit*, 16 VA. L. REV. 749, 750–58 (1930) (discussing how the American common law of torts has accommodated theories ranging from "actual fraud," which requires the intention to deceive, to "innocent misrepresentation," which merely causes loss).

46. RESTATEMENT (SECOND) OF TORTS § 525 (1976).

47. *Id*.

background knowledge that the speaker states or implies that she has in making a representation.[48] One might believe, then, that the Restatement sees awareness of falsity, not the intention to deceive, as the essence of the tort of fraudulent misrepresentation. But the Restatement also provides that one who makes a fraudulent misrepresentation is not liable unless she does so "for the purpose of inducing another to act or to refrain from action in reliance upon it."[49] Thus, fraud cannot exist without an intention and a goal.[50] Only the separate tort of negligent misrepresentation can be committed without such intention.[51]

2. *Goal Versus Awareness.* As I have demonstrated, a basic structural difference exists between the idea of core fraud, as articulated in Account A, and the idea of misrepresentation, as articulated in Account B. Core fraud is necessarily a goal-oriented behavior. Misrepresentation need not be.

Goals and motives are not to be confused. Goals are objectives; motives are reasons. Core fraud involves the goal of deception: the actor forms an objective of inducing action in another through deception and acts upon it. Her reasons for doing so may be simple or complex, financial or emotional, self- or other-regarding. Motive is of no consequence.[52]

Misrepresentation is not, in the first instance, a question of mental state at all. It simply requires that an actor make an utterance

48. *Id*. § 526.

49. *Id*. § 525.

50. Prosser lists the elements of "the tort cause of action in deceit" as (1) a false representation; (2) knowledge or belief in the falsity of the representation (or lack of sufficient information to make the representation) (known as "scienter"); (3) intention to induce the plaintiff to act or to refrain from acting in reliance on the representation; (4) justifiable reliance; and (5) damage. KEETON ET AL., *supra* note 25, § 105, at 728. If one understands, as I think one should, that the intention to induce someone to act on a false representation is the same thing as the intention to deceive, then Prosser is defining the tort of deceit as core fraud. *But see* Green, *supra* note 45, at 762 (asserting that the purpose to cause a victim to act on the basis of a misrepresentation "is entirely distinct from the purpose to defraud, deceive, or injure").

51. RESTATEMENT (SECOND) OF TORTS § 552.

52. KEETON ET AL., *supra* note 25, § 107, at 741. Professor Donald Langevoort states that a speaker's awareness of falsity is all that is required for securities fraud because the speaker's motive is not—and should not be—relevant to the question of scienter. Donald C. Langevoort, *Reflections on Scienter (and the Securities Fraud Case Against Martha Stewart That Never Happened)*, 10 LEWIS & CLARK L. REV. 1, 5–10 (2006). Langevoort seems to overlook how the question of purpose or goal falls in the space between an actor's mere awareness and her motive or reason for acting. The purpose of deception can serve many potential motives. The distinction is between matters within the actor's near sight and those out on her horizon.

or engage in an act that induces misapprehension in another.[53] To find the actor at fault, however, the law considers his mental processes, even if no actual mental state is ultimately required. The crucial point is what this fault inquiry will apply *to*: not the actor's goal, but rather whether the representation or conduct was false or misleading.[54]

This is a question of awareness, or lack thereof. Available mental states or fault measures include: practical certainty (knowledge); awareness of a high probability of falsity, coupled with the avoidance of information (willful blindness); conscious disregard of a substantial probability (recklessness); lack of awareness demonstrating substantial deviance (gross negligence or, in some formulations, recklessness); lack of awareness due to a failure to take due care (negligence); and simple lack of awareness, even in spite of due care (strict liability).

For a conception of fraud that is based in misrepresentation, an inquiry into the actor's awareness of the falsity of her representation, or of the tendency of her conduct to mislead, is both necessary and sufficient. For a conception based in core fraud, an inquiry into the actor's goal in making the false representation or engaging in the misleading conduct is necessary.

A remaining question is whether, in the instance of core fraud, an inquiry into the actor's fault with regard to the falsity of a representation or the tendency of certain conduct to mislead is also necessary.

It can be, for two reasons. First, a purpose to deceive, coupled with misleading statements or conduct, ordinarily entails an actor's having adverted, to some degree, to the falsity of her representation or to the tendency of her conduct to mislead. But the *way* in which she adverted can vary. She could have been sure of her representation's falsity, she could have been pretty sure and decided not to check, she could have known there was a risk of falsity and

53. *See, e.g.*, Game On Ventures, Inc. v. Gen. RV Ctr., Inc., 587 F. Supp. 2d 831, 838 (E.D. Mich. 2008) ("[C]ontrary to fraudulent misrepresentation and silent fraud, a plaintiff asserting an innocent misrepresentation claim need not prove that the defendant intended to deceive the plaintiff into relying on the false or misleading representation." (citation omitted)); W. Side Fed. Sav. & Loan Ass'n of N.Y.C. v. Hirschfeld, 476 N.Y.S.2d 292, 295 (App. Div. 1984) ("If we subtract from fraud the element of scienter the remainder constitutes the tort of innocent misrepresentation." (citation omitted)).

54. *Cf.* United States v. Svoboda, 347 F.3d 471, 478–79 (2d Cir. 2003) (clarifying the distinction in the crime of conspiracy between the element of knowledge of the existence and the goals of the conspiracy, for which the theory of willful blindness is relevant, and the element of intent to advance conspiracy toward its goals, for which such a theory is not permissible).

been indifferent to it, and so on. A conception of core fraud might, for example, require both a goal of deception and practical certainty that a representation is false; or it might require a goal of deception and only lack of due care as to whether a representation is false.

Second, in cases of core fraud, any inquiry into awareness has a nearly unavoidable evidentiary problem. Goals are not observable. The factual matter of falsity is usually at least partially observable. An ex post juridical determination about whether an actor's goal was to deceive will almost always include considering whether the actor was aware—and how aware she was—that her representation was false or that her conduct was misleading. By inference, the more aware she was, the more likely it is that she meant to deceive. Indeed, fraud cases often may be brought on nothing more than allegations of falsity, with the moving party relying on argument and inference to get all the way to judgment.

Two conclusions follow from the preceding discussion of goals and awareness. First, any conception of fraud must include consideration of the mental state or fault requirements that will apply to the actor's awareness. And second, if the question of awareness is not distinguished from the question of goals, confusion of core fraud with misrepresentation is likely to result. For example, if a court holds that fraud requires an intent to defraud and that an intent to defraud, in turn, requires scienter as to the falsity of the representation,[55] then the second fault standard has displaced the first.

This matter of awareness of falsity has long been challenging. Consider Professor William Prosser's classic treatise on torts, which talks about the required intent for the tort of fraud as "the intent to deceive" and defines it as "the intent that a representation shall be made, that it shall be directed to a particular person or class of persons, that it shall convey a certain meaning, that it shall be believed, and that it shall be acted upon in a certain way."[56] But the treatise goes on to say, "[O]bviously this intent [to deceive], which has been given the name of 'scienter' by the courts, must be a matter of belief, or of absence of belief, that the misrepresentation is true."[57] A bit further along, it explains that a speaker who asserts knowledge

55. *See, e.g.*, *In re* Ikon Office Solutions, Inc., 277 F.3d 658, 667 (3d Cir. 2002) (stating that, in an action for securities fraud, knowledge, or even recklessness, can establish the required "exacting threshold of scienter" with respect to the intent to deceive).

56. KEETON ET AL., *supra* note 25, § 107, at 741.

57. *Id*.

of a fact of which he does not in truth have knowledge will be "found to have the intent to deceive, not so much as to the fact itself, but rather as to the extent of his information."[58]

Consider also the discussion among British jurists in *Derry v. Peek*,[59] the seminal case on the tort of deceit, in which the evidentiary point was stated more clearly. Lord Herschell announced, "[F]raud is proved when it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false."[60] This statement has often been invoked in support of a concept of reckless fraud, a matter to which I turn shortly.[61]

But Lord Herschell quickly added, "[T]he third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states."[62] He noted, "I think there is here some confusion between that which is evidence of fraud, and that which constitutes it."[63] Lord Bramwell similarly pointed out in *Derry*: "[I]n all the judgments [of my colleagues] there is, I must say it, a confusion of unreasonableness of belief as evidence of dishonesty, and unreasonableness of belief as of itself a ground of action."[64]

---

58. *Id*. § 107, at 742. Holmes begins his discussion of fraud by saying that the actor must intend to deceive—in his formulation, intend "that the other should believe and act upon" a misrepresentation. OLIVER WENDELL HOLMES, JR., THE COMMON LAW 90 (Am. Bar Ass'n Publ'g 2009) (1881). But then, in a nearly impenetrable passage, Holmes dispenses with mental state, concluding that the whole matter really reduces to "an external standard of conduct" under which a statement that, objectively evaluated, would tend to mislead is, in fact, a statement made with the intent to deceive. *Id*. at 91–93. Holmes concedes that the tort of fraud is thus "more extensive than the sphere of actual moral fraud" because, "starting from the moral ground, it works out an external standard of what would be fraudulent in the average prudent member of the community, and requires every member at his peril to avoid that." *Id*. at 93. Holmes appears to have been working with a conception of fraud similar to the one described in Account B in Part I.C.1.

59. Derry v. Peek, (1889) 14 App. Cas. 337 (H.L.) (appeal taken from Eng.) (U.K.).

60. *Id*. at 374 (Lord Herschell L.J.).

61. *See, e.g.*, Sandberg v. Va. Bankshares, Inc., 979 F.2d 332, 346 & n.13 (4th Cir. 1992) (referencing *Derry* for the proposition that "conscious disregard of whether a statement is true satisf[ies] the scienter requirement"), *vacated*, No. 91-1873(L), 1993 WL 524680 (4th Cir. Apr. 7, 1993); United Trade Assocs. Ltd. v. Dickens & Matson (USA) Ltd., 848 F. Supp. 751, 761 (E.D. Mich. 1994) (citing *Derry* for the proposition that a reckless misrepresentation is sufficient to prove fraud); Conn. Nat'l Bank v. Giacomi, 10 Conn. L. Rptr. 66, 78 (Super. Ct. 1993) ("[A] statement recklessly made is one not *honestly* made.").

62. *Derry*, 14 App. Cas. at 374 (Lord Herschell L.J.).

63. *Id*. at 369.

64. *Id*. at 352 (Lord Bramwell L.J.).

3. *Level of Awareness*. Once the matters of purpose and awareness have been distinguished, one must consider the level of mental state or fault that is required to establish sufficient awareness of falsity or tendency to mislead. A fulsome conception of fraud must include some choices on this matter. Various bodies of fraud law have often called this the question of "scienter."

Scienter is a confusing word because its most natural meaning—and the one often associated with it—is knowledge.[65] But the term is used, at least in the area of securities fraud, to mean simply level of fault.[66] A statement like "scienter is required for liability" often is meant to do no more than rule out strict liability. In this form, scienter stands for a full menu of choices on the matter of awareness: knowledge, knowledge plus willful blindness, recklessness, gross negligence, or negligence.

Which level to choose is a function of the conception of fraud one wishes to pursue. A regime centered on the belief that fraud is a problem of costs and harm might—in its focus on results caused, not plans hatched—require a low level of fault or perhaps no scienter at all. The choice of a scienter definition might depend on such things as one's calculation of the relative costs of harm and its avoidance; whether the regime is compensatory, punitive, or injunctive; whether it regulates all actors or only particular industries; whether it affords class action relief or does not; and whether it is a matter of state or federal law.

A regime centered on culpability and blameworthiness—in its focus on responsibility for acts of deception—is likely to require not only some scienter but a high level of awareness. The choice of a scienter definition might depend on one's general views about the blameworthiness of negligent or reckless conduct, one's specific views about the blameworthiness of negligent or reckless acts in the context of fraud, and one's assessment of how risks of error with respect to

65. BLACK'S LAW DICTIONARY (9th ed. 2009) first defines scienter as "[a] degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act's having been done knowingly, esp. as a ground for civil damages or criminal punishment." *Id.* 1463; *see also* 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3411 (3d rev. ed. 2003) (defining scienter in the common-law action for deceit as knowledge of the falsity of one's representation).

66. An alternative definition of scienter is "[a] mental state consisting in an intent to deceive, manipulate, or defraud." BLACK'S LAW DICTIONARY, *supra* note 65, at 1463; *see also* 7 LOSS & SELIGMAN, *supra* note 65, at 3414 (stating that scienter has been used to mean "everything from knowing falsity . . . to such non-action as is virtually equivalent to negligence or even liability without fault").

the question of intent to deceive might vary according to the rule that applies to the actor's awareness of the falsity of her representation or the tendency of her conduct to mislead.

Whatever level of fault is chosen, it must be clearly specified. Specifying the level of fault is especially important with regard to recklessness because the law of fraud has often been unclear as to whether reckless fraud exists or should exist.[67]

The most precise and demanding definition of recklessness, and the one most often used in criminal law, is the one found in the Model Penal Code: the conscious disregard of a substantial and unjustifiable risk—provided that the actor's disregard of that risk grossly deviates from how a reasonable person would act in the same circumstances.[68] Under this definition, recklessness is a form of knowledge. The actor is actually aware of the risk that inheres in the situation, as opposed to, in the case of a full knowledge requirement, having the practical certainty that it inheres. I call this the "conscious-disregard" form of recklessness.[69]

As is well known, other formulations of recklessness treat it as a heightened form of negligence.[70] In these formulations, recklessness does not generally require the actual, subjective disregard of a risk. As with negligence, the actor must have failed to advert to and act upon a risk—the difference from negligence being that the actor's

67. *See infra* text accompanying notes 147–71.

68. MODEL PENAL CODE § 2.02(2)(c) (1962).

69. *See* James A. Henderson, Jr. & Aaron D. Twerski, *Intent and Recklessness in Tort: The Practical Craft of Restating Law*, 54 VAND. L. REV. 1133, 1144 (2001) ("[F]or recklessness to be present, the actor must not only know that the risk is great and easily avoidable, but she also must subjectively entertain callous indifference to the plight of would-be victims.").

70. *See* United States v. Shortman, 91 F.3d 80, 81 (9th Cir. 1996) ("Gross negligence is defined as wanton or reckless disregard for human life." (citations omitted) (quoting United States v. Keith, 605 F.2d 462, 463 (9th Cir. 1979)) (internal quotation marks omitted)); Bd. of Cnty. Comm'rs v. Liberty Grp., 965 F.2d 879, 884 (10th Cir. 1992) ("[T]he line between gross negligence and recklessness is a fine one at best. '[T]here is often no clear distinction at all between [recklessness] and 'gross' negligence, and the two have tended to merge and take on the same meaning.'" (second and third alterations in original) (quoting KEETON ET AL., *supra* note 25, § 34, at 214)); St. Onge v. Detroit & Mackinac Ry. Co., 321 N.W.2d 865, 867 (Mich. Ct. App. 1982) ("The term 'gross negligence'—when it is used to describe an extreme departure from the ordinary standard of care—has essentially the same meaning as the term 'recklessness.'"); RESTATEMENT (SECOND) OF TORTS § 500 (1964) (defining "reckless disregard of safety" as "knowing or having reason to know of facts which would lead a reasonable man to realize, not only that his conduct creates an unreasonable risk of physical harm to another, but also that such risk is substantially greater than that which is necessary to make his conduct negligent").

failure represents more than a lack of due care.[71] The failure demonstrates a high level of social deviance. That deviance relates to the degree of the risk, the nature of the risk, or a combination of the two. I call this the "super-negligence" form of recklessness.[72]

The argument in favor of choosing the conscious-disregard form of recklessness would proceed as follows. It is blameworthy—or should require compensation, or should be deterred, et cetera—to cause another to act to her detriment in reliance on a representation that one knows is false, or perhaps even to attempt to do so. When an actor makes a representation on which another relies to her detriment, and the actor knows that the representation may be false, the actor is doing something that justifies sanction just as much as if she knows it is false.[73] She represents herself as speaking authoritatively on a matter of importance when she knows that what she is uttering might be poppycock.[74] One could say that she does in fact have full knowledge: she knows that she is falsely representing to the listener, by implication, her own level of knowledge about what

71. *See, e.g.*, HOLMES, *supra* note 58, at 92–93 (finding recklessness in the fraud context when "the data for the statement were so far insufficient that a prudent man could not have made it without leading to the inference that he was indifferent" and noting that "if a man makes his statement on those data, he is liable, whatever was the state of his mind, and although he individually may have been perfectly free from wickedness in making it").

72. Though I do not think it necessary here, one could drill deeper into the concept of recklessness. Professor Kim Ferzan argues for consideration of a third form of recklessness that she calls "opaque recklessness." Kimberly Kessler Ferzan, *Opaque Recklessness*, 91 J. CRIM. L. & CRIMINOLOGY 597, 598–99 (2001). According to Professor Ferzan, an actor is exercising opaque recklessness when she considers the riskiness of her behavior in some general sense (for example, it is dangerous to drive too fast) but does not consider the specific risk for which she may be liable (for example, if I drive too fast, I may strike and kill that pedestrian possibly crossing a block down the road). *Id.* Professor Ken Simons argues that there are three aspects or types of recklessness: (1) "cognitive" recklessness, involving awareness of risk (a "belief state"); (2) reckless indifference, involving "callousness" toward risk (a "desire state"); and (3) recklessness in the gross negligence sense (a conduct standard, not a mental state). Kenneth W. Simons, *Rethinking Mental States*, 72 B.U. L. REV. 463, 465 (1992).

73. A more ambitious version of this argument has been mounted by Professor Larry Alexander, who argues that recklessness should be viewed as equivalent to intent and knowledge for the general purposes of the criminal law because, properly defined, recklessness involves the same "basic moral vice of insufficient concern for the interests of others." Larry Alexander, *Insufficient Concern: A Unified Conception of Criminal Culpability*, 88 CALIF. L. REV. 931, 931 (2000).

74. *See* Derry v. Peek, (1889) 14 App. Cas. 337, 368 (H.L.) (appeal taken from Eng.) (U.K.) (Lord Herschell L.J.) ("Any person making [a statement that he intends another to act upon] must always be aware that the person to whom it is made will understand, if not that he who makes it *knows*, yet at least that he *believes* it to be true. And if he has no such belief he is as much guilty of fraud as if he had made any other representation which he knew to be false, or did not believe to be true.").

she asserts.[75] This form of recklessness is "substantial and unjustifiable" in cases in which the actor's decision to go forward with her statement is genuinely deviant because the known risk that the statement is poppycock is high.

The argument in favor of liability based on the super-negligence version of recklessness is very different. That argument would assert that it is blameworthy not to be careful about the accuracy of one's statements when others might rely on such statements to their detriment, that law ought to give people incentives to be more careful about what they say when others are likely to rely on their statements, and that people who rely on the careless statements of others to their detriment are entitled to compensation. This principle, the argument would maintain, applies with force only in cases in which the carelessness is serious.

One could play out similar arguments about choosing fault formulations based on knowledge, negligence, or strict liability, but the basic point has been made: a clear conception of fraud requires taking a position on the matter of the actor's awareness, and that position should include a precise articulation of the applicable doctrinal measure of awareness.

4. *Criminal Fault*. If one's conception of fraud is to include the availability of criminal sanctions, further questions about mental state arise. First, is one prepared to impose criminal sanctions for what the law has called mere misrepresentation? One might permit such a regime if it carried relatively light penalties, perhaps limited to fines. But criminal fraud regimes in the United States typically make lengthy prison terms available.[76] I am not aware of any serious scholarly argument in favor of basing criminal liability for fraud on, for example, simple negligence. And a wide range of criminal regimes in the United States at least purport to require proof of "intent to defraud."[77]

---

75. *See id*. (stating that someone who is reckless as to whether her representation is false should be just as liable as someone who does not believe that her representation is true).

76. *See, e.g.*, 18 U.S.C. § 1344 (2006) (providing a thirty-year maximum prison term for bank fraud); *id.* § 1348 (prescribing a twenty-five-year maximum prison term for securities or commodities fraud).

77. *See, e.g.*, United States v. Jones, 641 F.3d 706, 710 (6th Cir. 2011) (health-care fraud); United States v. Warshak, 631 F.3d 266, 312 (6th Cir. 2010) (bank fraud); Cox v. State, 964 P.2d 1235, 1236 (Wyo. 1998) (check fraud).

Second, how does one distinguish civil and criminal fraud? Criminal liability is usually justified on the grounds that certain behavior is particularly blameworthy or is only deterrable with especially strong sanctions. The nature of an actor's mental processes and the extent of the harm she inflicts or risks inflicting are the two primary means for measuring these criteria. Both retributivist and consequentialist lines of argument might place significant weight on mental processes and harm.

In the case of fraud, then, criminal liability might be distinguished from civil liability either because of the actor's blameworthy mental state or because she imposed, or risked imposing, a particularly serious or large loss. Although the degree of harm is a major influence on prosecutorial discretion and on the decisionmaking of judges and juries, it is difficult to embody in the law of fraud. How much and what kind of harm, stated in general terms, is sufficient to make a fraud case "really criminal"? Intuitions may be strong at the level of individual cases, but articulating a standard is difficult.[78]

The dimension of mental state is a more promising route to general principles distinguishing civil fraud from criminal fraud. After all, the very existence of criminal liability for fraud requires justification, and mental state turns out to be important for understanding why criminal punishment is justified in some cases of fraud.[79] But my agenda here is not to make the case for criminal liability for fraud. I am instead taking it as a given feature of positive law and am asking what constitutes its essential elements. Those necessary elements include an aggravating factor that distinguishes it from civil liability for fraud. And that aggravating factor is most easily located in mental state.

If criminal liability for fraud requires a higher level of culpability, what is it? It could be intent to defraud—simply the purpose to deceive. But that choice would entail two commitments: First, it would mean that civil liability for fraud does not require a purpose to deceive—otherwise, one has not distinguished the two forms of

78. The U.S. SENTENCING GUIDELINES MANUAL (2010) uses a relatively crude dollar-loss-to-the-victim metric, *id.* § 2B1.1, which has been subject to abundant criticism, *see, e.g.*, Samuel W. Buell, *Reforming Punishment of Financial Reporting Fraud*, 28 CARDOZO L. REV. 1611, 1612 (2007).

79. *See* Buell, *supra* note 22, at 2022–36 (explaining how an actor's awareness of the wrongfulness of his deceptive conduct can justify his punishment for fraud).

liability. Second, it would mean that having the goal of deception is sufficient to warrant criminal punishment.

Neither commitment is easy to make. I have already explored why one's conception of fraud might require a purpose to deceive in all instances, including for civil liability. And one might be uncomfortable with the idea that a deceptive purpose alone marks one for criminal sanctions. Markets are full of deceptive conduct, some of which is common enough to be relatively innocuous and a lot of which goes by other names—like sales, advertising, and savvy negotiation. The blameworthiness of deception, like the blameworthiness of lying, can vary a great deal with context.

What if one therefore would prefer a higher level of fault for criminal fraud liability? I have previously developed the argument that this higher level of culpability—as a matter of both positive law and normative justification—should be awareness of the wrongfulness of one's own conduct.[80] In other words, the actor must not only intend to deceive the listener but also intend to deceive the listener in a manner the actor knows is wrongful in the particular context in which she acts.

In easy cases of fraud, this mental state is implicit in the actor's conduct. Everyone knows operating a billion-dollar Ponzi scheme is not only fraudulent, but wrongful. There is no question that Bernie Madoff knew what he was doing was wrong.[81] In harder cases of fraud, however—particularly ones that involve novel forms of deception—awareness of wrongfulness can usually be established only by evidence that the actor engaged in efforts to cover her tracks or to prevent others from seeing the true nature of what she was doing. Such acts are sometimes labeled with the ancient term "badges of fraud."[82]

A complete understanding of fraud would require book-length treatment. I have sketched enough of the general project of

---

80. *Id*. In the criminal securities context, Professor Michael Seigel argues for a similar requirement of knowledge of wrongfulness, although Seigel describes the requirement—confusingly, in my view—as affording the defendant a "weak mistake-of-law defense." Seigel, *supra* note 28, at 1609–10.

81. That is, unless he was delusional. Perhaps many flagrant fraudsters are. But, as in other areas of criminal law, delusion that does not rise to the level of legal insanity cannot negate liability.

82. *See, e.g.*, Buell, *supra* note 22, at 1983 ("'[B]adges of guilt' . . . ha[ve] been an important feature of the law's response to commercial behavior since the seventeenth century.").

understanding fraud to turn now to the more specific question at hand: How should one understand the concept of securities fraud?

II. WHAT IS SECURITIES FRAUD?

Rule 10b-5, the principal font of the law of securities fraud, is about to turn seventy.[83] It can make a plausible claim to being the most consequential piece of American administrative law.[84] But the rule has an awkward textual structure and virtually no administrative history.[85] Its status as a legal Swiss army knife—used to punish, to

83. The SEC adopted Rule 10b-5 in 1942. 7 LOSS & SELIGMAN, *supra* note 65, at 3407–08.

84. The rule has sparked thousands of lawsuits, causing billions of dollars to change hands. *See Securities Class Action Clearinghouse*, STANFORD LAW SCH., http://securities.stanford.edu/settle.html (last visited Nov. 9, 2011) (providing summaries of settlement amounts for securities class action lawsuits). It has produced hundreds of judicial opinions, including opinions by some of the most esteemed jurists of the past century. A Westlaw search limited to federal courts of appeals decisions in which the term "securities fraud" appears in the synopsis of the case produced 1589 opinions as of November 9, 2011. *See, e.g.*, Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979) (Powell, J.); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (Powell, J.); Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980) (Friendly, J.); United States v. Simon, 425 F.2d 796 (2d Cir. 1969) (Friendly, J.). The rule has also routinely spawned headlines in the nation's leading papers. A Westlaw search of *The New York Times* database since 1980 for items that include "fraud" in the headline and "securities fraud" in the body of the text produced 424 articles as of November 9, 2011. A Westlaw search in *The Wall Street Journal* abstracts database since 1990 produced 643 article abstracts in which the term "securities fraud" appears, as of November 9, 2011. The rule has sent hundreds of people to prison, some for decades. *See, e.g.*, United States v. Skilling, 554 F.3d 529, 542 (5th Cir. 2009) (reporting that the district court had sentenced the defendant, a former CEO of Enron, to over twenty-four years of imprisonment for one count of conspiracy, twelve counts of fraud, five counts of making false statements, and one count of insider trading), *aff'd in part, vacated in part, and remanded*, 130 S. Ct. 2896 (2010); United States v. Rigas, 583 F.3d 108, 113, 126 (2d Cir. 2009) (affirming the district court's twelve- and seventeen-year sentences for bank fraud against John and Timothy Rigas, the former CEO and CFO of Adelphia Communications, Corp., respectively); United States v. Ebbers, 458 F.3d 110, 112, 130 (2d Cir. 2006) (affirming a twenty-five-year sentence for conspiracy and securities fraud against the former CEO of WorldCom). The Federal Bureau of Justice Statistics (BJS) shows that over 1100 people were criminally prosecuted for securities fraud between 1994 and 2008. This data was obtained by visiting http://bjs.ojp.usdoj.gov/fjsrc/tsec.cfm and following the prompts to produce a report for the number of total defendants that were prosecuted from 1994 to 2008 under 15 U.S.C. § 78j (Section 10 of the Securities Exchange Act of 1934). And, of course, the rule has been fodder for an enormous literature. As of November 9, 2011, eighty-four papers that use the term "securities fraud" in their titles have been posted on the Social Science Research Network (SSRN). A Westlaw search in the Journals and Law Reviews (JLR) database for articles using the term "securities fraud" in their titles produced 281 works as of November 9, 2011. A similar search in the HeinOnline Law Journal Library database produced 302 articles as of November 9, 2011.

85. *See* 5B ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS §§ 6:1–:3, at 6-3 to -11 (2011) (describing the scant legislative and administrative history of the statute and the rule); *see also* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 99 (3d ed. 2003) ("[T]he Securities Exchange Act of 1934 was a marvel of irresolution.

enjoin, to shame, to regulate, to fine, to debar, to sue, to compensate, and more—makes it perhaps understandable that its core meaning has become fractured, confused, and even at odds with itself.

The law of securities regulation does not stand on a single conception of fraud. "Securities fraud" is an umbrella term for several causes of action, some of which are for forms of core fraud and some of which are for forms of misrepresentation. Given the voluminous materials available on securities fraud, a tour through this body of law might seem unnecessary. But I believe that lawyers and policymakers have failed to notice how strange and untethered the concept of securities fraud has become.

In this Part, to focus attention on the nature and extent of the problem, I guide the reader somewhat briskly through the current landscape of securities fraud law—first, by explaining the structure of the statutes and rules; second, by summarizing how the courts have described the essential requirements of those statutes and rules; third, by showing the substantial confusion in the current doctrine relating to mental state and fault; and finally, by situating the law of insider trading within my general description of the law of securities fraud.

A. Structure of the Statutory and Regulatory Scheme

When lawyers talk about securities fraud, they usually mean conduct that violates Rule 10b-5 of Title 17 of the Code of Federal Regulations. For three reasons, the term "securities fraud" must also be understood to refer to Section 17 of the Securities Act of 1933 ('33 Act).[86] First, Section 17 can be deployed by the SEC in civil regulatory actions and by the Department of Justice (DOJ) in criminal prosecutions, though not by plaintiffs in private lawsuits.[87] Second, Rule 10b-5's antifraud language was drawn directly from the text of Section 17, with only slight variations.[88] And third, the courts have

---

On most controversial substantive issues, Congress had been stalemated. Rather than providing the new Commission with a clear mandate, the legislators had granted the agency authority to study the controversy or issue its own rules.").

86. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006); *id.* § 17.

87. *Id.* §§ 20, 24; Maldonado v. Dominguez, 137 F.3d 1, 3 (1st Cir. 1998).

88. 5B JACOBS, *supra* note 85, § 6:3, at 6-11; 7 LOSS & SELIGMAN, *supra* note 65, at 3408. The language of the two prohibitions varies some. The full texts follow, with points of significant difference in italics. Section 17 of the '33 Act makes it a violation "in the *offer* or sale of any securities . . . directly or indirectly":

> (1) to employ any device, scheme, or artifice to defraud, or

sometimes interpreted Rule 10b-5 and Section 17 in relation to one another, although important distinctions have been drawn between them.[89]

Textually, the securities fraud regime works like this: Section 17 of the '33 Act prohibits: (1) schemes or artifices to defraud, (2) false statements of fact or omissions that make truthful affirmative statements misleading, and (3) acts or practices that operate as frauds

---

> (2) to obtain money or property *by means of any untrue statement* of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any *transaction*, practice, or course of business which operates or would operate as a fraud or deceit upon *the purchaser*.

Securities Act of 1933 § 17 (emphasis added). Rule 10b-5 makes it a violation "directly or indirectly" and "in connection with the *purchase* or sale of any security":

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To *make any untrue statement* of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any *act*, practice, or course of business which operates or would operate as a fraud or deceit upon *any person*.

17 C.F.R. § 240.10b-5 (2011) (emphasis added). Section 17 is thus broader, potentially applying to those who use the false representations of others. *See* SEC v. Tambone, 597 F.3d 436, 442–48 (1st Cir. 2010) (en banc) (exploring this distinction in depth and rejecting the theory that persons who merely have some role in the dissemination of the misrepresentations of others could be held liable under the second prong of Rule 10b-5).

Alas, the origins of Section 17's language—and thus Rule 10b-5's—shed little light on how to construe the text. Congress appears to have borrowed the statutory language primarily from New York's antifraud provision for the securities markets, the Martin Act, N.Y. GEN. BUS. LAW § 352-c (McKinney 1996), which, in turn, had borrowed from Maryland's antifraud statute, Act of Apr. 16, 1920, ch. 552, 1920 Md. Laws 1135, the textual origins of which are obscure. *See Federal Securities Act: Hearing on H.R. 4314 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. *passim* (1933) (discussing various state-level antifraud statutes, including those in Maryland and New York); *Securities Act: Hearing on S. 875 Before the S. Comm. on Banking & Currency*, 73d Cong. *passim* (1933) (discussing the Martin Act during a debate about the federal securities act); Decatur H. Miller, *A Prospectus on the Maryland Securities Act*, 23 MD. L. REV. 289, 293–94 (1963) (discussing the origins of Maryland's antifraud statute); Letter from George W. Hodges to Tracy Stagg (Apr. 25, 1921), *reprinted in* N.Y. STATE LIBRARY, BILL JACKET COLLECTION, ch. 649, at 6 (discussing the need to pass an antifraud law in New York that is similar to the Maryland antifraud law); Letter from Arthur W. Loasby to Nathan L. Miller, Governor of N.Y. (Apr. 12, 1921), *reprinted in* N.Y. STATE LIBRARY, *supra*, ch. 649, at 3 (noting that the New York antifraud statute "follows quite closely the Maryland statute").

89. *See, e.g.*, Aaron v. SEC, 446 U.S. 680, 687–700 (1980) (examining the SEC's duty to establish scienter when seeking injunctions for violations of Section 17 or Rule 10b-5 and holding that scienter is required to establish violations of Rule 10b-5 and Section 17(a)(1) but not Sections 17(a)(2) or 17(a)(3)).

or deceits.[90] Section 10 of the Securities Exchange Act of 1934 ('34 Act)[91] prohibits "any manipulative or deceptive device or contrivance" contravening any rule the SEC might make against such things.[92] And, like Section 17, Rule 10b-5, the SEC's principal exercise of authority under Section 10, prohibits: (1) schemes or artifices to defraud, (2) false statements of fact or omissions that make truthful affirmative statements misleading, and (3) acts or practices that operate as frauds or deceits.[93]

As a matter of statutes and rules, the law of securities fraud is extremely broad. It can be read to cover both core fraud—in its talk of "schemes," "fraud," and "deceit"—and cases of misrepresentation that involve only a harm-focused inquiry—in its talk of false statements and acts that "operate as" deceits.[94] One can divide causes of action for securities fraud along three dimensions: (1) the nature of the moving party, (2) the type of conduct alleged to violate the law, and (3) the relief sought.

Private plaintiffs may only bring lawsuits under Rule 10b-5 and may only seek damages.[95] Such lawsuits may be based on an allegation of a scheme to defraud, a false statement or omission, or an act or practice that "operates as" a fraud.[96] Thus, three private causes of action for securities fraud exist, all for monetary sanctions.

The SEC may bring administrative actions or lawsuits under both Rule 10b-5 and Section 17.[97] The SEC may seek disgorgement of

---

90. United States v. Naftalin, 441 U.S. 768, 774 (1979) (explaining that Section 17 prohibits three distinct categories of misconduct).

91. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78oo (2006 & Supp. III 2009).

92. *Id.* § 10.

93. 17 C.F.R. § 240.10b-5.

94. *See In re* Enron Corp. Sec. Derivative & "ERISA" Litig., 529 F. Supp. 2d 644, 678–90 (S.D. Tex. 2006) (discussing the differences between Rule 10b-5 cases based on misrepresentations and cases based on failures of disclosure); Swack v. Credit Suisse First Bos., 383 F. Supp. 2d 223, 238–39 (D. Mass. 2004) (discussing the three different categories of conduct that can implicate Rule 10b-5).

95. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971); Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513–14 (E.D. Pa. 1946); *see also* Maldonado v. Dominguez, 137 F.2d 1, 6, 9–10 (1st Cir. 1998) (permitting the plaintiff's Rule 10b-5 claims to proceed but dismissing the plaintiff's Section 17 claims because there is no implied private cause of action under Section 17).

96. *See, e.g.*, *In re* Am. Cont'l/Lincoln Sav. & Loan Sec. Litig., 140 F.R.D. 425, 428–29 (D. Ariz. 1992) (explaining that plaintiffs must prove either a scheme to defraud, a false statement or omission, or a fraudulent act or practice to succeed in their Rule 10b-5 claims).

97. Securities Act of 1933 § 8, 15 U.S.C. § 77h-1 (2006); *id.* § 20; Securities Exchange Act of 1934 §§ 21A–21D.

profits, fines, or injunctive relief—most often including bars on further violations and/or on service as a corporate officer or director.[98] All such actions may be based on an allegation of a scheme to defraud, a false statement or omission, or an act or practice that "operates as" a fraud.[99] Setting aside the agency's choice between an administrative forum and a district court,[100] six types of SEC action for securities fraud are possible, one for each combination of a type of wrongdoing with a type of relief.

The DOJ may bring criminal actions for securities fraud under both Rule 10b-5 and Section 17, provided that the cases involve "willful" conduct.[101] The DOJ may seek typical criminal sentences consisting of restitution, fines, and/or imprisonment.[102] Prosecutions may be based on an allegation of a scheme to defraud, a false statement or omission, or an act or practice that "operates as" a fraud. Thus, the DOJ may bring three types of criminal action for securities fraud.

For those keeping score, that makes a dozen causes of action for securities fraud. The pie could be divided other ways. And, in most cases, the moving party is likely to allege multiple types of violating conduct and to seek various forms of relief. In addition, private lawsuits, SEC actions, and DOJ prosecutions are often initiated in

---

98. Securities Act of 1933 § 8.

99. *See supra* note 96.

100. *See supra* note 97.

101. Securities Act of 1933 § 24; Securities Exchange Act of 1934 § 32. Since 2002, the Department of Justice has also been able to prosecute for securities fraud under 18 U.S.C. § 1348 (2006), which covers any person who

> knowingly executes, or attempts to execute, a scheme or artifice (1) to defraud any person in connection with . . . any security of an issuer [required to register or report under the '34 Act]; or (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of . . . any security of an issuer [required to register or report under the '34 Act].

Id. The case law on this statute is not well developed. *See* United States v. Mahaffy, No. 05-CR-613, 2006 WL 2224518, at *10–19 (E.D.N.Y. Aug. 2, 2006) (explaining that the statute had been patterned on mail and wire fraud statutes and thus should be interpreted similarly and exploring the relevance of Title 15 securities law to the "in connection with" requirement of the statute). Notice that this statute does not include a parallel provision to the second (misrepresentation or omission) prongs of Rule 10b-5 and Section 17. It could, and probably should, be argued that this statute covers only core fraud and requires proof of a purpose to deceive.

102. Securities Act of 1933 § 24; Securities Exchange Act of 1934 § 32; 18 U.S.C. § 3551 (2006). *See generally* 18 U.S.C. §§ 3551–3586 (2006) (detailing sentencing procedures and available penalties).

overlapping fashion for a single matter of wrongdoing.[103] The point of organizing things as I have is to make identifying the various forms of action that can be involved in the supposedly singular category of securities fraud easier.

B. Elements, According to the Federal Courts

These statutory and rule provisions cannot be read in isolation. The law of securities fraud is one of the most heavily judicially created bodies of federal law. Even such a self-respecting textualist as the late Chief Justice Rehnquist famously called the law of Rule 10b-5 "a judicial oak which has grown from little more than a legislative acorn."[104] Thus, one needs to apply the judicial gloss, to the extent that it is discernible, to each of the actions I have identified.

For the private causes of action, the Supreme Court has said that a plaintiff must prove six elements: (1) "a material misrepresentation (or omission)"; (2) "scienter, i. e., a wrongful state of mind"; (3) "a connection with the purchase or sale of a security"; (4) "reliance"; (5) "economic loss"; and (6) "'loss causation,' i. e., a causal connection between the material misrepresentation and the loss."[105] But this is not quite right. A material misrepresentation or omission is not the only kind of conduct that can violate Rule 10b-5, as the Supreme Court itself has recognized.[106] Element (1) must be understood to include schemes to defraud and acts or practices that "operate as"

---

103. The Enron affair, for example, resulted in criminal prosecutions, *e.g.*, United States v. Skilling, 638 F.3d 480, 481 (5th Cir. 2011); a class action lawsuit, Newby v. Enron Corp., 542 F.3d 463, 467 (5th Cir. 2008); and various SEC enforcement actions, *see Spotlight on Enron*, SEC, http://www.sec.gov/spotlight/enron.htm (last modified May 11, 2010).

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

105. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (emphasis omitted).

106. *See* Chiarella v. United States, 445 U.S. 222, 227–30 (1980) (explaining how silence in the face of a duty to disclose can constitute fraud); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 152–54 (1972) (explaining how nondisclosure can constitute fraud); *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472–74 (1977) (holding that a breach of fiduciary duty alone does not constitute securities fraud in the absence of some form of deception); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181–82 (1963) (holding that a registered investment advisor commits fraud when he purchases "shares of security for his own account shortly before recommending that security for long-term investment and then immediately sell[s] the shares at a profit"); Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 383–85 (5th Cir. 2007) (discussing in depth the necessity of a showing of a duty to support a Rule 10b-5 claim based on a theory of fraud by nondisclosure). *But see* United States v. Schiff, 602 F.3d 152, 162–63 (3d Cir. 2010) (stating that a duty to disclose under Rule 10b-5 does not arise from a corporate executive's general fiduciary relationship with shareholders).

fraud—that is, to mean something more like "conduct that falls within the scope of Rule 10b-5(a)(1), (2), or (3)."

The elements of SEC regulatory actions vary from this scheme in the following ways: The fourth, fifth, and sixth elements mostly fall away. When it charges securities fraud, the SEC is not a victim seeking damages, so it need not show that it did anything, much less that it acted in reliance on anything the defendant did. Nor does the SEC need to show that it suffered any loss.[107] The law could require the SEC to prove those things on behalf of someone else—a harmed investor who is not a party to the action, for example—but the law does not, for perhaps obvious reasons. The SEC needs to prove something like damages only to the extent that it seeks, among other remedies, disgorgement of the defendant's profits.[108]

The SEC's burden differs from that of the private plaintiff in at least three respects. The SEC can proceed under both Section 17 and Rule 10b-5; according to a Supreme Court holding,[109] Section 17 requires less than Rule 10b-5 to establish "scienter." In addition, the SEC can bring actions for injunctive relief that, in terms of the common-law roots of securities fraud, are more like actions in equity than, as with private lawsuits for damages, actions in law.[110] Finally, the SEC may bring actions against persons who "aid and abet" others in committing securities fraud, but private plaintiffs may not.[111]

In other respects, the SEC's cases for securities fraud are like private plaintiffs'. The SEC must have a theory based on one of Section 17's or Rule 10b-5's forms of violating conduct—including that the form of conduct satisfies the materiality requirement of the law of securities fraud.[112] The SEC must establish some form of scienter.[113] And the defendant must have acted in connection with the purchase or sale of a security.[114]

107. *See, e.g.*, SEC v. Rana Research, Inc., 8 F.3d 1358, 1363–64 (9th Cir. 1993) (explaining that the SEC need not prove reliance to establish a Rule 10b-5 cause of action).

108. *See* Securities Exchange Act of 1934 § 21, 15 U.S.C. § 78u-2(b)(1)(2) (2006).

109. *See supra* note 89.

110. *See, e.g.*, *id.* at 701–02 (allowing the SEC to bring an action for injunctive relief).

111. Securities Exchange Act of 1934 § 20; Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 769 (2008); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994).

112. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 445–47 (1976).

113. *See, e.g.*, SEC v. Rana Research, Inc., 8 F.3d 1358, 1363–64 (9th Cir. 1993) (noting that the SEC must establish scienter to sue under Rule 10b-5).

114. *See, e.g.*, SEC v. Tambone, 597 F.3d 436, 443 (1st Cir. 2010) (explaining that the SEC's authority under Section 10(b) is limited to actions that are in connection with the purchase or

Finally, the government may bring a criminal prosecution for securities fraud. The DOJ is situated much like the SEC. It need not prove anything like reliance, damages, or loss causation unless, at sentencing, it wants to establish that the defendant ought to be ordered to pay restitution to the victims. Indeed, securities fraud includes attempt liability. As under the law of mail and wire fraud, the DOJ need only establish that someone pursued a "scheme" to defraud, even if that scheme never got off the ground.[115] But the DOJ still must prove a form of violating conduct, including satisfying the materiality requirement, and it must establish scienter.[116] A criminal prosecution, of course, requires proof beyond a reasonable doubt, not by a mere preponderance of the evidence.

Before turning to the matter of mental states, I should note that the law of securities fraud is not clear—across all forms of its civil and criminal remedies—on the extent to which nondisclosure and conduct alone can support a claim of fraud.[117] The courts have clearly recognized that some forms of nondisclosure in some fiduciary and similar relationships can constitute securities fraud.[118] But the statutes, rules, and decisions have provided no general rule or justification for precisely which circumstances are likely to trigger duties of heightened candor.[119]

---

sale of securities); SEC v. Wolfson, 539 F.3d 1249, 1256 (10th Cir. 2008) (same); Geman v. SEC, 334 F.3d 1183, 1190–92 (10th Cir. 2003) (same); *Rana Research*, 8 F.3d at 1363–64 (same).

115. *E.g.*, United States v. Frey, 42 F.3d 795, 800 (3d Cir. 1994) (explaining that success is not a required element for fraud).

116. *See, e.g.*, United States v. Teyibo, 877 F. Supp. 846, 861 (S.D.N.Y. 1995) (outlining the elements of securities fraud).

117. This is the intersection of the fraud axes of act (a), context (c), and type of harm (e) discussed in Part I. *See supra* text accompanying notes 24–27.

118. As I will discuss, insider trading law is largely based on a requirement to "disclose or abstain" from trading. *Compare* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472–74 (1977) (holding that a breach of fiduciary duty alone does not constitute fraud under the '34 Act in the absence of some form of deception), *with* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192–95 (1963) (holding that, in an action by the SEC for injunctive relief, a fiduciary's nondisclosure of disloyal conduct can constitute fraud under the Investment Advisers Act of 1940, 31 U.S.C. §§ 3729–3731 (2006), in part because, in actions at equity, the common law of fraud did not always require proof of harm or intent to defraud).

119. *See* Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty To Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1646–74 (2004) (highlighting "major areas in which there is inconsistency on the basic duty question"); *see also* Gregory Klass, *Meaning, Purpose and Cause in the Law of Deception* 2–3 (Georgetown Pub. Law & Legal Theory Research Paper Series, Research Paper No. 11-18, 2011), *available at* http://ssrn.com/abstract=1756831 ("[T]here is a deep error in the common law tendency to conflate fraud by misrepresentation, fraud by concealment, and fraud by nondisclosure, which in fact involve different regulatory approaches . . . .").

C. *The Scienter Mess*

Now comes the hard part—and the nub of the matter. As I established in Part I, distinctions among conceptions of fraud are embodied in doctrine largely through the treatment of mental state and fault. A core, culpability-based conception of fraud, based on Account A, requires both the purpose to deceive and some level of fault with regard to the falsity of the actor's representation or the tendency of the actor's conduct or omission to mislead. Misrepresentation, based on Account B, does not require the purpose to deceive and can be established, depending on the normative stance the law chooses, by various levels of fault with regard to the falsity of the actor's misrepresentation or the tendency of the actor's conduct or omission to mislead. The Supreme Court's statement that securities fraud requires "scienter, i. e., a wrongful state of mind" thus merely begins the inquiry that is critical to determining which conception of fraud the law embodies.[120]

In this Section, I explain—as best I can, given the poor state of the doctrine—what "scienter" means in each type of action for securities fraud.

1. *Private Lawsuits*. In 1976, the Supreme Court held that, in a private lawsuit for securities fraud under Rule 10b-5, a plaintiff must prove "'scienter'—intent to deceive, manipulate, or defraud."[121] The Court's primary justification for this holding was that Section 10 of the '34 Act authorizes the SEC to make rules only against "manipulative or deceptive device[s] or contrivance[s]."[122] These words imply seriously culpable conduct—planning, scheming, and the like. Given this language, it would not be a valid exercise of the SEC's powers to apply Rule 10b-5 to less faulty conduct.

One might think, on the basis of this holding, that Rule 10b-5 rests on a conception of core fraud. But that is not the case. The Supreme Court quickly added in a footnote: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."[123] And the Court expressly stated that it was not deciding the question whether

120. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2004) (emphasis omitted).

121. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

122. *Id*. at 197–201 (quoting Securities Exchange Act of 1934 § 10, 15 U.S.C. 78j (2006)) (internal quotation mark omitted).

123. *Id*. at 193 n.12.

recklessness could suffice for Rule 10b-5's scienter requirement.[124] The Court has not revisited this question for over thirty years; in the meantime, the federal appellate courts have uniformly held that recklessness *can* establish scienter under Rule 10b-5.[125]

Based on this state of the law, one must conclude that a private lawsuit for securities fraud can be brought for misrepresentation, in addition to core fraud. While speaking out of one side of its mouth to suggest that Rule 10b-5 requires intent to defraud, the Court spoke out of the other side to suggest that recklessness might suffice. Moreover, it ignored the distinction between the two levels of mental state involved in fraud: the purpose to deceive and the level of fault with respect to the falsity of the relevant representation. As a result, the courts of appeals have all said that recklessness can satisfy the scienter requirement. Those courts also have too frequently failed to distinguish between: (1) the two levels of mental state involved in fraud—an actor's purpose and her fault with respect to falsity—and (2) the two forms of recklessness—conscious-disregard recklessness and super-negligence recklessness.[126] As I discussed in Part I.C.3, conscious-disregard recklessness is a form of knowledge, whereas super-negligence recklessness is a form of fault that does not involve awareness.

124. *Id.*; *see also* Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980) (declining to address the same question).

125. *See, e.g.*, Theoharous v. Fong, 256 F.3d 1219, 1225 (11th Cir. 2001) (defining recklessness in the super-negligence sense, that is, as "an extreme departure from the standards of ordinary care," and stating that recklessness is sufficient to make out scienter (quoting Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1282 n.18 (11th Cir. 1999))); *In re* Phillips Petrol. Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989) ("We have also recognized that recklessness on the part of a defendant meets the scienter requirement of Section 10(b) and Rule 10b-5." (citing Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 649 (3d Cir. 1980))); Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 651 (2002) ("Since [*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976),] every court of appeals that has addressed the issue has held that recklessness satisfies the scienter requirement of Section 10(b).").

126. *See, e.g.*, United States v. Precision Med. Labs., Inc., 593 F.2d 434, 446 (2d Cir. 1978) ("The phrases 'reckless disregard of whether the statements made were true' and 'conscious purpose to avoid learning the truth' mean essentially the same thing." (quoting United States v. Sarantos, 455 F.2d 877, 882 (2d Cir. 1972))); United States v. Hanlon, 548 F.2d 1096, 1101–02 (2d Cir. 1977) (noting that trial courts have confused the concepts of reckless indifference and conscious avoidance); Slakoff v. United States, 8 F.2d 9, 10 (3d Cir. 1925) ("If he did not do this, but acted with such gross carelessness and indifference to the truth of the representations contained in the statements as to warrant the conclusion that he acted fraudulently, then his conviction may stand.").

A further complication remains. As has been heavily documented, the class action dominates the modern industry of private securities litigation, and almost no cases go to trial.[127] The critical action lies in pleading, motions to dismiss, and settlement negotiations that are conducted in the shadow of pleading requirements and standards of review for dismissal.[128] Seeking to reduce the expenses arising out of weak or meritless cases, Congress updated the '34 Act with the Private Securities Litigation Reform Act of 1995 (PSLRA).[129] Under the PSLRA, private plaintiffs must satisfy a heightened pleading standard with respect to the element of scienter.[130] The Supreme Court has held that to satisfy this statutory pleading standard, plaintiffs must allege specific facts that give rise to a strong inference that the defendant acted with the required scienter, meaning an inference "at least as compelling" as any other inference available from the facts in the complaint.[131]

The Court did not, in its decision on pleading, revisit the question of what mental state, if any, suffices for scienter—though the decision confusingly talked about the issue as the standard required to support an inference of "fraudulent intent."[132] The courts of appeals have since held that the new pleading rule in the PSLRA does not alter their prior rulings holding that a showing of recklessness suffices.[133]

127. *See* STEPHANIE PLANCICH & SVETLANA STARYKH, NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2009 YEAR-END UPDATE 9–13 (2009) (providing statistical data on the promulgation and settlement rates of private securities class action suits); James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions To Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 418 (2005) ("Settlements are the end game for securities class action suits. . . . [S]everal hundred securities class actions are settled annually, [but] fewer than one or two securities class action suits are tried in any year.").

128. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 238–40, 246–48, (2d ed. 2008); *see also, e.g.*, *In re* Synchronoss Sec. Litig., 705 F. Supp. 2d 367, 398–401 (D.N.J. 2010) (conducting an analysis of whether scienter had been established under the standard of proof required at the pleading stage).

129. Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

130. Securities Exchange Act of 1934 § 21D, 15 U.S.C. 78u-4(b)(2) (2006).

131. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2510 (2007).

132. *Id*. at 2504.

133. *See* Greebel v. FTP Software, Inc., 194 F.3d 185, 199–201 (1st Cir. 1999) ("[T]he PSLRA did not address the substantive definition of scienter."); Phillips v. LCI Int'l, Inc., 190 F.3d 609, 620 (4th Cir. 1999) ("The PSLRA did not change . . . the kind of evidence a plaintiff must adduce to demonstrate scienter . . . [b]ut . . . the PSLRA does seek to heighten the

Where does that leave matters? Under existing law, plaintiffs in civil securities fraud actions may sue for merely reckless conduct of the super-negligence variety. That is, a plaintiff could seek damages under Rule 10b-5 on the ground that an actor issued a factually untrue material statement, was unaware of the untruth, and was unaware due to such extreme carelessness that she should have known that the representation was not true.[134]

I do not know whether the majority of securities fraud class actions, or even a substantial portion of them, involve only such conduct. Usually plaintiffs plead multiple theories, including both a scheme to defraud and the making of misrepresentations and/or omissions. Typically, plaintiffs allege both that the defendant knew of an untruth and that she recklessly disregarded the question of

standard for pleading scienter . . . ."); Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1281–84 (11th Cir. 1999) ("[W]e hold that the [PSLRA] does not prohibit the practice of alleging scienter by pleading facts that denote severe recklessness, the standard previously approved of by this Circuit . . . ."); *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 549–52 (6th Cir. 1999) ("[I]t is clear that Congress changed the pleading, but not the state of mind, requirements applicable to § 10(b) and Rule 10b-5 cases."); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 532–35 (3d Cir. 1999) ("[W]e believe [the PSLRA] was intended to modify procedural requirements while leaving substantive law undisturbed."). Interestingly, courts disagree over whether a pleading based on facts about the defendant's "motive and opportunity" to commit fraud can be sufficient to clear the scienter hurdle. *See, e.g.*, Institutional Investors Grp. v. Avaya, Inc., 564 F.3d 242, 276–79 (3d Cir. 2009) (discussing the three different standards applied by the various circuits to determine whether a plaintiff sufficiently pled scienter under the PSLRA).

134. *See, e.g.*, Second Amended Complaint at 297, *In re* Fannie Mae Sec. Litig., No. 1:04-CV-1639 (D.D.C. Aug. 15, 2006) ("These Defendants knew, or should have known in the exercise of reasonable care, that their statements regarding the Company's financial statements, accounting policies and practices, and internal financial controls during the Loss Period were materially false and misleading."); Second Consolidated Amended Complaint at 7, *In re* Tommy Hilfiger Sec. Litig., No. 1:04-CV-07678-RO (S.D.N.Y. Sept. 28, 2004) ("[D]efendants . . . were aware, or recklessly disregarded, that the false and misleading statements were being issued regarding the Company, and approved or ratified these statements, in violation of the federal securities laws."); *see also* 8 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3688–89 (3d rev. ed. 2004) (warning against the tendency of a definition of recklessness such as, for example, "an extreme departure from the standards of ordinary care" to slide too close to allowing liability for negligence (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977))); Milich, *supra* note 28, at 180–81 (criticizing courts for allowing "a negligence-like standard" to creep back into the law of securities fraud under the mantle of recklessness). Even a leading case that stressed the importance of recklessness's being "the functional equivalent of intent" defined it in negligence-like terms: "[T]he danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing . . . . [This definition] measures conduct against an external standard which, under the circumstances of a given case, results in the conclusion that the reckless man should bear the risk of his omission." Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977).

falsity.[135] Because these cases nearly always settle before summary judgment, much less trial, measuring the proportion of cases in which the plaintiff could prove only recklessness is probably impossible. In addition, some courts say that "should have known" is not enough and that recklessness requires a knowing disregard of a substantial risk that the relevant representation was false.[136] Finally, the demanding pleading standard with respect to scienter means that facts sufficient to raise a "strong inference" often are also the kinds of facts that suggest more than mere recklessness.[137]

The point is only that Rule 10b-5 and its doctrine permit lawsuits for conduct beyond core fraud. The Supreme Court has said that Section 10 of the '34 Act is "a catchall provision, but [that] what it catches must be fraud."[138] But if the Court permits recklessness to establish scienter, then the "fraud" that Section 10 catches is not the kind of fraud that requires a deceptive actor. This is odd in light of the Court's determination that the language of Section 10 of the '34 Act, which speaks of "manipulation" and "deception," limits the reach of Rule 10b-5.[139]

That the insurance market recognizes and even welcomes this contradiction reveals the lack of conceptual coherence in this area of law. The directors' and officers' liability (D&O) insurance policies purchased by all American corporations routinely exclude—for moral hazard, historical, and other reasons—coverage for what the industry calls "real fraud," by which it means, roughly, intentional fraud.[140]

---

135. *See, e.g.*, [Corrected] Second Consolidated Amended Class Action Complaint at A-55, *In re* Scholastic Corp. Sec. Litig., No. 99 CIV. 2447 JFK, 2000 WL 91939 (S.D.N.Y. Jan. 27, 2000), *rev'd*, 252 F.3d 63 (2d Cir. 2001) (stating that "defendants knew, or were reckless in not knowing," that the rate of return for certain book titles was rising).

136. *See, e.g.*, Robin v. Arthur Young & Co., 915 F.2d 1120, 1127–28 (7th Cir. 1990) (holding that the plaintiffs' allegations that the defendant "should have known" the relevant facts were insufficient to allege recklessness in a private action for securities fraud).

137. *See Tellabs*, 127 S. Ct. at 2504–05 ("To qualify as 'strong' within the intendment of § 21D(b)(2), we hold, an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.").

138. Chiarella v. United States, 445 U.S. 222, 234–35 (1980).

139. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173–74 (1994) ("[T]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976)) (internal quotation marks omitted)).

140. TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 186–87 (2010).

Meanwhile, the fact that private liability can be established based on recklessness—and the fact that almost all suits settle—allows insurers to pay claims for securities fraud liability without admitting to covering real fraud, even in cases in which real fraud was committed and ultimately could have been proven.

This slippage sustains the status quo in the existing market for D&O policies and gives plaintiffs good reason to rely on ample allegations of recklessness when pleading and settling fraud suits.[141] Maybe this state of affairs is beneficial for the D&O insurance market, and maybe what is good for that market is good for everyone—those are inquiries beyond the ambitions and competence of this Article—but the situation appears, at the least, to be jury-rigged.

2. *SEC Actions.* The SEC navigates even murkier waters on the matter of scienter. Unlike private plaintiffs, the SEC can bring actions under both Rule 10b-5 and Section 17.[142] Because the two provisions use almost identical language, the availability of both options might not seem important. But the Supreme Court has made it important by holding that negligence is sufficient to satisfy the scienter requirement of at least one portion of Section 17.[143]

The argument goes like this: The scope of Rule 10b-5 is limited by its enabling statute, Section 10 of the '34 Act, which applies only to "manipulative and deceptive device[s] and contrivance[s]."[144] Section 17, unlike Rule 10b-5, is a statute, with no limitation beyond its own language. Because the second of Section 17's three prongs talks about misstatements of fact rather than the sort of "fraud," "manipulation," or "schemes" named in its other two prongs, the statute's second prong should be read to sanction the careless misleading of others.[145] This argument hardly seems to harmonize these two provisions of securities regulation, a fact that is particularly noteworthy given that Rule 10b-5 was virtually copied from Section 17.[146]

141. *Id.* at 187–88.

142. *See supra* notes 95–97 and accompanying text.

143. Aaron v. SEC, 446 U.S. 680, 697 (1980).

144. Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (2006).

145. *Aaron*, 446 U.S. at 691–97. This reading, of course, raises the question why the Court has not found the parallel second prong of Rule 10b-5 to be invalid as exceeding the SEC's rulemaking authority under Section 10 of the '34 Act.

146. *See supra* note 88 and accompanying text.

The result is that the SEC is able to bring enforcement actions for securities fraud without having to specify whether its grievance is that the defendant committed fraud in the sense of real deceit, or merely that she acted carelessly in important matters involving other people's money. The SEC's complaints routinely allege violations of both Rule 10b-5 and Section 17 and often use allegation language like "the defendant knew or should have known" or "was aware or must have been aware."[147] These cases—though not subject to the special pleading rules for private lawsuits—also almost uniformly settle. And they usually settle under terms in which the defendant "neither admits nor denies" the wrongdoing alleged in the SEC's complaint.[148] Thus, the public almost never learns—and the SEC almost never has to decide—whether the defendant committed core fraud or merely some form of misrepresentation.

To return to the Goldman Sachs case, the SEC alleged that Goldman "negligently" violated Section 17 and that it "knowingly or recklessly" violated Rule 10b-5.[149] Then, following a hue and cry about whether Goldman had committed a major fraud,[150] the case settled without a trial or any admission of wrongdoing, and with Goldman agreeing to a permanent injunction that covered violations of Section 17 but did not mention Rule 10b-5.[151] Did Goldman plan to deceive the buyer by hiding the people and methods it had used to select the feeble mortgages supporting the securities products it sold? Or was Goldman merely careless, or grossly careless, about whether the buyer had been misled? Was this buyer even misled? These answers are unavailable not only because the case settled but also because the law permitted the SEC to investigate and file its case without committing to any of these theories.[152]

---

147. *See, e.g.*, Complaint at 6, SEC v. Noncek, No. 09-CV-02387 (D.D.C. Dec. 15, 2009); Complaint at 6, SEC v. Queri, No. 08CV01367 (W.D. Pa. Sept. 30, 2008); Complaint at 2, SEC v. Pliner, No. 07-CV-00495 (D.D.C. Mar. 15, 2007).

148. *See* Buell, *supra* note 7, at 89.

149. Complaint, *supra* note 2, at 21.

150. *See supra* notes 1–5.

151. Consent of Defendant Goldman, Sachs & Co., *supra* note 8, at 1.

152. The Dodd-Frank legislation promises to make the matter more opaque. It includes a provision that authorizes the SEC to proceed against persons who "recklessly" aid and abet the securities fraud violations of others. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929O, 124 Stat. 1376, 1862 (codified at 15 U.S.C. § 78t(e) (Supp. IV 2011)). The idea of reckless accessorial liability is even more elusive than the idea of reckless fraud. It is black-letter criminal law that, with few exceptions, one cannot aid another in committing an offense without intending for the offense to succeed. JOSHUA DRESSLER,

The SEC's Enforcement Division thus routinely exercises sanctioning authority over conduct that extends potentially well beyond a conception of fraud based in purposeful deception. Though the SEC talks about policing securities fraud when it uses both Section 17 and Rule 10b-5,[153] it may be policing something quite different, such as conduct that causes losses to investors. Such an enforcement program might be beneficial, but its merits have not been sufficiently discussed, either now or at the births of the '33 and '34 Acts and Rule 10b-5.

3. *Criminal Prosecutions*. Alas, the situation is worse in criminal actions. One might think that the law would be clearer because the criminal sphere is the one place with statutory guidance on mental state. Section 32 of the '34 Act and Section 24 of the '33 Act state that anyone who "willfully" violates any provision of the Acts can be fined and imprisoned.[154] These sections seem to imply a heightened mental state requirement for criminal penalties.

But these statutory provisions have a major problem. In an instance of poor foresight, the drafters of the '33 and '34 Acts adopted criminal culpability standards that apply in blanket fashion to all of the Acts' conduct rules and regulations. The Acts and their corresponding regulations contain voluminous and highly diverse provisions. These range from picayune filing requirements to serious prohibitions on fraud and market manipulation.[155] The drafters of the '34 Act seem to have glimpsed this problem because they included a provision in Section 32 stating that imprisonment may not be imposed

UNDERSTANDING CRIMINAL LAW 477–82 (5th ed. 2009). Helping another in a particular endeavor is a goal-oriented behavior. And criminal law does not exculpate accomplices who fail to succeed in their efforts to assist criminal ventures. *See* MODEL PENAL CODE § 5.01(3) (1962) (imposing attempt liability on a person who acts as an accomplice to a person who did not successfully complete a planned crime). A reckless state of mind does not suffice for accomplice liability because it is nonsensical to speak, for example, of a person consciously disregarding the risk that her work as a lookout might help a bank robber escape. She is either acting as a lookout in the hopes that he will get away, or she is not a lookout at all.

153. *See, e.g.*, SEC Charges Securities Fraud in Internet Foreign Currency Trading Scheme, Litigation Release No. 16,055, 69 SEC Docket 287 (Feb. 8, 1999); SEC Charges Investment Adviser with Securities Fraud, Litigation Release No. 15,988, 68 SEC Docket 1998 (Nov. 30, 1998).

154. Securities Act of 1933 § 24, 15 U.S.C. § 77x (2006); Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff (2006).

155. *Compare, e.g.*, 17 C.F.R. § 240.10b-5 (2011), *with, e.g.*, 17 C.F.R. § 230.164 (2011).

on anyone who proves that she did not have knowledge of the rule she has been criminally charged with violating.[156]

This state of affairs has bedeviled the courts. For two reasons, "willfully" cannot mean "knowing that one is breaking the securities laws." First, if the government had to prove knowledge of the law to establish a willful violation, defendants would have no need for the statutory partial defense that allows one to avoid prison by proving lack of knowledge of the relevant rule.[157] Statutes are to be read, when possible, to avoid redundancy.[158] Second, ignorance of the law generally does not excuse serious criminal offenses, including fraud.[159] It would severely hamper the law of securities fraud if defendants were permitted to argue that they did not know that fraud in connection with securities transactions was illegal, or even that they did not know that their particular conduct counted as securities fraud in the eyes of the law—especially given the rapid evolution of financial products.

The Supreme Court has never identified the scienter required for a criminal conviction for securities fraud. The lower federal courts have issued dozens of opinions making a mess of the matter.[160] Depending on which federal court one asks—and when one asks—a

---

156. Securities Exchange Act of 1934 § 32. The '33 Act has no parallel language, which is surprising, given that the '33 Act's rules are often more arcane than those of the '34 Act. *See* Securities Act of 1933 § 24.

157. United States v. Tarallo, 380 F.3d 1174, 1188 (9th Cir. 2004).

158. TRW Inc. v. Andrews, 534 U.S. 19, 31 (2001).

159. United States v. Reyes, 577 F.3d 1069, 1079–81 (9th Cir. 2009); *Tarallo*, 380 F.3d at 1185–88; United States v. Stockheimer, 157 F.3d 1082, 1088–89 (7th Cir. 1998); United States v. Hollis, 971 F.2d 1441, 1451–52 (10th Cir. 1992); United States v. Knueppel, 293 F. Supp. 2d 199, 203 n.1 (E.D.N.Y. 2003). Some courts, however, have permitted a defendant, at least under the strict terms of the statute, to argue an affirmative defense of lack of knowledge of the existence of Rule 10b-5, though I know of no case in which such an argument has been successful. *See* United States v. Behrens, 644 F.3d 754, 755 (8th Cir. 2011) (holding that a defendant was entitled to a defense that he had no knowledge of Rule 10b-5 and remanding to the district court to determine whether he had met his burden of proof); *see also* Ratzlaf v. United States, 510 U.S. 135, 149 (1994) (noting the "venerable principle that ignorance of the law generally is no defense" before holding that "Congress may decree otherwise" in particular contexts, such as the regulatory crime of structuring financial transactions); Cheek v. United States, 498 U.S. 192, 199–200 (1991) (noting the same principle before finding that Congress has created a mistake-of-law defense in limited contexts, including the nonpayment of taxes); Dan M. Kahan, *Ignorance of the Law Is an Excuse—But Only for the Virtuous*, 96 MICH. L. REV. 127, 145–49 (1997) (describing *Cheek v. United States*, 498 U.S. 192 (1991), as providing an ignorance defense solely for honest mistakes that violate laws not backed by moral norms).

160. For a longer tour through the particulars of many of these cases, see Seigel, *supra* note 28, at 1590–98.

criminal conviction for securities fraud might require (from the most to the least demanding rule):

1. willfulness, which means awareness that one is doing something wrongful[161] but not necessarily illegal;[162]
2. specific intent to defraud, which means a purpose to mislead;[163]
3. specific intent to defraud, which includes knowledge of the falsity of the relevant representation, willful blindness as to its falsity, or deliberate disregard as to the risk of its falsity;[164]
4. specific intent to defraud, which includes acting recklessly under circumstances in which the defendant "should have known" or "must have known" of the risk that the relevant representation was false;[165]
5. specific intent to defraud, which includes acting recklessly, with the meaning of recklessness undefined;[166]
6. just knowledge;[167]
7. just recklessness, with no apparent distinction between the level of scienter required for criminal and civil liability;[168] or

---

161. United States v. Kaiser, 609 F.3d 556, 567–70 (2d Cir. 2010); *Reyes*, 577 F.3d at 1079–80; United States v. Peltz, 433 F.2d 48, 54–55 (2d Cir. 1970).

162. United States v. English, 92 F.3d 909, 914–15 (9th Cir. 1996).

163. United States v. Piepgrass, 425 F.2d 194, 199–200 (9th Cir. 1970); Rice v. United States, 149 F.2d 601, 603 (10th Cir. 1945).

164. United States v. Gentile, 530 F.2d 461, 469–70 (2d Cir. 1976); United States v. Mackay, 491 F.2d 616, 623 (10th Cir. 1973); United States v. Amick, 439 F.2d 351, 363–64 (7th Cir. 1971); United States v. Benjamin, 328 F.2d 854, 862–63 (2d Cir. 1964).

165. United States v. DeSantis, 134 F.3d 760, 764 (6th Cir. 1998); United States v. Natelli, 527 F.2d 311, 320–23 (2d Cir. 1975).

166. United States v. Tarallo, 380 F.3d 1174, 1188–89 & n.5 (9th Cir. 2004); United States v. Sawyer, 799 F.2d 1494, 1501–02 (11th Cir. 1986); United States v. Farris, 614 F.2d 634, 638 (9th Cir. 1979); United States v. Henderson, 446 F.2d 960, 966 (8th Cir. 1971); Elbel v. United States, 364 F.2d 127, 133–34 (10th Cir. 1966); United States v. Goyal, No. CR 04-00201 MJJ, 2008 WL 755010, at *8 (N.D. Cal. Mar. 21, 2008); United States v. Cen-Card Agency/C.C.A.C., 724 F. Supp. 313, 316–17 (D.N.J. 1989); United States v. Koenig, 388 F. Supp. 670, 711–12 (S.D.N.Y. 1974).

167. *Koenig*, 388 F. Supp. at 711–12.

168. United States v. Gutstein, No. 91-50704, 1992 WL 354151, at *1 (9th Cir. Nov. 30, 1992); Williams v. United States, No. 92-1110, 1992 WL 332029, at *3 (1st Cir. Nov. 13, 1992); United States v. Boyer, 694 F.2d 58, 59–60 (3d Cir. 1982); Sparrow v. United States, 402 F.2d 826, 828 (10th Cir. 1968); *see also* United States v. Charnay, 537 F.2d 341, 348 (9th Cir. 1976)

8. albeit rarely, simply failure of due care.[169]

Many of these opinions rely on a long line of cases interpreting the federal mail, wire, and bank fraud statutes that—alarmingly—also hold that recklessness can "establish" the specific intent to defraud.[170] And many of these opinions elide the distinction between the evidentiary and constitutive questions discussed in Part I, never making clear whether an actor's recklessness can be viewed as simply making it more likely that she had a purpose to deceive or as substituting fully for the intent to defraud.[171]

(stating that the law of Rule 10b-5 does not vary in civil and criminal contexts except as to the government's burden of proof).

169. United States v. Schaefer, 299 F.2d 625, 629 (7th Cir. 1962); Stone v. United States, 113 F.2d 70, 75 (6th Cir. 1940); *see also* United States v. Meyer, 359 F.2d 837, 839 (7th Cir. 1966) (holding that a defendant cannot prevail on a good-faith defense to a securities fraud charge "if he could have ascertained the true facts by the exercise of that degree of care expected of a reasonably prudent person").

170. United States v. Isaiah, 434 F.3d 513, 520–21 (6th Cir. 2006); United States v. Munoz, 233 F.3d 1117, 1135–36 (9th Cir. 2000); United States v. Prows, 118 F.3d 686, 692 (10th Cir. 1997); United States v. Cochran, 109 F.3d 660, 664–65 (10th Cir. 1997); United States v. Coyle, 63 F.3d 1239, 1243 (3d Cir. 1995); United States v. Reddick, 22 F.3d 1504, 1507–08 (10th Cir. 1994); United States v. Gay, 967 F.2d 322, 326–27 (9th Cir. 1992); United States v. Mann, 884 F.2d 532, 535–36 (10th Cir. 1989); United States v. Woods, 877 F.2d 477, 480 (6th Cir. 1989); United States v. Dick, 744 F.2d 546, 551 (7th Cir. 1984); United States v. Cusino, 694 F.2d 185, 187 (9th Cir. 1982); United States v. Frick, 588 F.2d 531, 536 (5th Cir. 1979); United States v. McDonald, 576 F.2d 1350, 1358–59 (9th Cir. 1978); United States v. Love, 535 F.2d 1152, 1157–58 (9th Cir. 1976); United States v. Reicen, 497 F.2d 563, 571 (7th Cir. 1974); United States v. Edwards, 458 F.2d 875, 881 (5th Cir. 1972); Gusow v. United States, 347 F.2d 755, 756 (10th Cir. 1965); Irwin v. United States, 338 F.2d 770, 774 (9th Cir. 1964); Babson v. United States, 330 F.2d 662, 664 (9th Cir. 1964); Bentel v. United States, 13 F.2d 327, 329 (2d Cir. 1926); Slakoff v. United States, 8 F.2d 9, 10 (3d Cir. 1925); Corliss v. United States, 7 F.2d 455, 456–57 (8th Cir. 1925); Kaplan v. United States, 229 F. 389, 389 (2d Cir. 1916); United States v. Philip Morris USA, Inc., 449 F. Supp. 2d 1, 897 (D.D.C. 2006); United States v. Epstein, 152 F. Supp. 583, 588–89 (E.D. Pa. 1957). *But see* United States v. Precision Med. Labs., Inc., 593 F.2d 434, 445–46 (2d Cir. 1978) (stating that recklessness suffices to establish the mental state for mail fraud only if it rises to the level of "conscious purpose to avoid learning the truth"). The nadir in this line of cases might be this formulation: "In order to convict, the jury [is] required to find not only the presence of 'reckless indifference' in the making of the statements in question, but that [the statements] were made with 'intent to defraud.' Though the definitions are faintly circular, they present the concept fairly." United States v. Cronn, 717 F.2d 164, 170 (5th Cir. 1983); *see also* United States v. Themy, 624 F.2d 963, 965 (10th Cir. 1980) (providing the ipse dixit that "indifference to the truth of statements made to induce others to action *amounts to* fraudulent intent" (emphasis added)); United States v. Quadro Corp., 928 F. Supp. 688, 696 (E.D. Tex. 1996) (stating that the elements of mail fraud include both intent to defraud and knowledge or recklessness as to falsity, but later stating that "[i]f specific intent cannot be proven, the government must show that the defendants 'made material misrepresentations of fact with reckless disregard to their truth or falsity'" (quoting *Cen-Card Agency*, 724 F. Supp. at 316–17)).

171. *See, e.g.*, *Boyer*, 694 F.2d at 59–60; United States v. Natelli, 527 F.2d 311, 320–24 (2d Cir. 1975); *Henderson*, 446 F.2d at 966; *Elbel*, 364 F.2d at 133–34; *Stone*, 113 F.2d at 75; *see also*

As far as I have been able to discover, the courts have made virtually no effort to distinguish between the goal-oriented mental state involved in a defendant's purpose to deceive and the knowledge-based mental state involved in a defendant's awareness of the falsity of her representation or the tendency of her conduct or omission to mislead. Nor have the courts made much effort to distinguish among forms of recklessness. The elements have been confused to the point that courts sometimes simply say that recklessness establishes intent—which is nonsensical and, for criminal lawyers, as unpleasant as the sound of fingernails on a chalkboard.[172]

Although I doubt prosecutors deliberately take on such cases, the result is that a person can be convicted and imprisoned for securities fraud in the United States on the theory that she was very

---

Prows, 118 F.3d at 692 (implying, in a mail fraud case, that specific intent to defraud can be inferred from recklessness as to falsity); United States v. Hoffman, 918 F.2d 44, 46–47 (6th Cir. 1990) (suggesting, in a bank fraud case, that recklessness can equate to specific intent to defraud because it is evidence of intent); United States v. Welch, 248 F. Supp. 2d 1061, 1070–71 (D. Utah 2001) (stating, in a mail fraud case, that a scheme to defraud requires intent but that indifference to truth can be evidence of intent); 8 LOSS & SELIGMAN, *supra* note 134, at 3676–77 (suggesting that recklessness has grown in importance in the law of scienter as it has been relied upon as a way of inferring the intent to defraud).

172. *See* 8 LOSS & SELIGMAN, *supra* note 134, at 3676–77 (stating that intent to defraud has "taken on a coloration of recklessness" in some of the case law). New York's famous securities antifraud statute, the Martin Act, is even broader than the federal scheme in its statutory language; serves as an all-purpose tool for civil, regulatory, and criminal liability; and has produced judicial fogginess about fault standards and the distinction between fraud and misrepresentation. Engaging in "[a]ny fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale" or making "[a]ny promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances" is a misdemeanor violation of the Martin Act. Martin Act § 1, N.Y. GEN. BUS. LAW § 352-c(1) (McKinney 1996). But felony liability attaches only if one "intentionally engages in any scheme constituting a systematic ongoing course of conduct with intent to defraud ten or more persons or to obtain property from ten or more persons by false or fraudulent pretenses, representations or promises." *Id.* § 5; *see also, e.g.*, People v. Landes, 645 N.E.2d 716, 717–18 (N.Y. 1994) (stating that the Martin Act covers conduct "which, in some instances, may be criminal because deceptive or misleading even absent proof of scienter or intent"); People v. Rachmani, 525 N.E.2d 704, 707–08 (N.Y. 1988) (stating that in an injunctive action, the Martin Act imposes strict liability for all deceitful practices); People v. Federated Radio Corp., 154 N.E. 655, 657 (N.Y. 1926) (stating that the Martin Act covers "all deceitful practices contrary to the plain rules of common honesty"); People v. Sala, 695 N.Y.S.2d 169, 177 (App. Div. 1999) (stating that intent to defraud is necessary for a felony conviction under the Martin Act, but then stating that intent can be inferred from knowledge and that intent means simply "an intentional act constituting fraud," defined as including all "deceitful practices"); People v. Tellier, 155 N.Y.S.2d 245, 255 (Sup. Ct. 1956) (stating that negligence is sufficient for civil liability under the Martin Act); People v. Photocolor Corp., 281 N.Y.S. 130, 137 (Sup. Ct. 1935) (stating that "something less than legal fraud will suffice to invoke the injunctive powers of the Martin Act").

careless about whether what she did or said might mislead another person to his detriment. This possibility ought to, at a minimum, provoke serious controversy. Lengthy prison sentences for financial crimes involving only negligence, gross negligence, or even conscious-disregard recklessness swim against a considerable tide of cases insisting on knowledge or intent for white-collar and regulatory crime offenses carrying significant prison sentences.[173]

The best that can be said for the state of the doctrine is that these scienter distinctions do not matter in most cases. One might argue that what the courts really mean when they talk about recklessness is not something constitutive about fraud but is rather an evidentiary point: a prosecutor is permitted to argue in a securities fraud case that facts showing a defendant's indifference to the truth of her representations tend to support the inference that she intended to deceive the listener. But this assertion might not be true in all cases. The argument therefore treads on dangerous ground, potentially opening the door to converting the evidentiary point into a constitutive change in the crime of fraud.

The only way to guard against this kind of leakage—if one even believes such measures are effective—would be with a jury instruction of a type that I do not believe is given in securities fraud cases. The jury would need to be told something like: "If you find that the defendant consciously disregarded a risk that her representation was false, you may consider that fact as evidence with respect to the question whether she specifically intended to defraud the victim; but you must find beyond a reasonable doubt that she had the purpose to deceive, not merely that she was indifferent to a risk that the victim would be misled."[174]

---

173. *See, e.g.*, Staples v. United States, 511 U.S. 600, 605 (1994) ("[W]e must construe the statute in light of the background rules of the common law, in which the requirement of some *mens rea* for a crime is fairly embedded." (citation omitted)). *See generally* Joseph E. Kennedy, *Making the Crime Fit the Punishment*, 51 EMORY L.J. 753 (2002) (demonstrating how the Supreme Court has increasingly required proof of higher levels of mens rea in the area of regulatory crimes as statutory and guidelines punishments for those crimes have increased).

174. *See* Milich, *supra* note 28, at 186–89 (distinguishing, in the securities fraud context, between the evidentiary approach to recklessness, which uses it as a way of concluding that the defendant was subjectively at fault, and the disjunctive approach, which allows complete substitution of objective recklessness for a finding of subjective fault); Seigel, *supra* note 28, at 1605–10 (arguing, in the securities fraud context, the importance of distinguishing the use of an actor's recklessness as an evidentiary matter from its use as the substantive standard of ultimate liability).

D. Insider Trading

Before turning to normative implications, a few words about the special but prevalent problem of insider trading are necessary. Most insider trading has not been banned by statutes and regulations.[175] It is, by judicial construction of Rule 10b-5, a form of securities fraud.[176] The law of insider trading is thus also vulnerable to the problems associated with sloppy thinking about the concept of fraud.

The fit between insider trading and securities fraud is famously awkward.[177] Many scholars believe that insider trading ought to be prohibited, but this view is by no means universal.[178] This Article, which aims to improve understanding of the relationship between fraud and securities fraud, has no stake in that contest. The question relevant to this Article is how restrictions on insider trading fit within general antifraud rules[179] and on which conception of fraud they stand.

---

175. *But see* 17 C.F.R. §§ 240.10b5-1 to -2 (2011) (codifying certain aspects of insider trading doctrine and providing certain safe harbors).

176. CHOI & PRITCHARD, *supra* note 128, at 354–66.

177. *See* Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 889 (2010) ("[D]ealing with insider trading through an antifraud rule is like trying to fit a square peg into a round hole.").

178. *See* United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) ("Who would knowingly roll the dice in a crooked crap game?" (quoting Schlanger v. Four-Phase Sys. Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982)) (internal quotation mark omitted)). The standard arguments for and against insider trading prohibitions are reviewed—and supplemented with an argument that these prohibitions enhance the quality of corporate governance—in James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628. *See also* Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 444 (2001) ("[N]either the courts, the legislature, nor the Securities and Exchange Commission . . . has clearly or convincingly articulated what social policy the insider trading prohibition is meant to further . . . ."); Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark*, 31 J. CORP. L. 167, 167 (2005) ("This Article briefly reexamines the great debates on the role of insider trading in the corporate system from the perspectives of efficiency of capital markets, harm to individual investors, and executive compensation."); M. Todd Henderson, *Insider Trading and CEO Pay* 3 (Univ. of Chi. Law Sch. Inst. for Law & Econ., Working Paper No. 521, 2010), *available at* http://ssrn.com/abstract=1605170 ("[T]here is a missing piece to the pay debate—the compensation insiders implicitly receive through the ability to convert their equity into cash. This Paper provides new evidence that the size of the insider-trading component of implicit compensation is significant . . . .").

179. *See* Hazen, *supra* note 177, at 887 ("The federal securities laws' primary weapon against insider trading is the general antifraud Rule 10b-5.").

Insider trading is a type of nondisclosure fraud that is situated along the context axis, axis (a), explained in Part I. The seller/buyer defrauds her counterparty in a trade by not disclosing that she has advantageous inside information—and that her decision to trade is based on that information—when the information is of a type that the counterparty would not expect her to exploit.[180] The insider trading prohibition is often described as a "disclose or abstain" rule because there is no deception, and thus no fraud, if the seller/buyer tells her counterparty about the particular inside information she uses to trade.[181]

Saying that insider trading is a form of nondisclosure fraud does not make much headway. The problem with treating nondisclosure as fraud is deciding under what circumstances nondisclosure is deceptive. Economic exchange is full of perfectly acceptable information disparities. "Disclose everything you know" would be a silly and disastrous rule for any market. Moreover, to say that disclosure is required when one has a duty to disclose is conclusory. Legal duties exist as a result of normative decisions to advance particular objectives.

The problem in insider trading law has been specifying the scope of the duty to disclose.[182] A duty to disclose all informational advantages before trading would sweep too broadly. There is not, and should not be, a right of equal knowledge in securities markets, where industrious actors should be encouraged and rewarded. Insider trading law aims at a sometimes difficult-to-specify category of unfair, inefficient, or otherwise-undesirable informational advantages.[183] It is good when a trader does research to gain an advantage. It is bad

180. *See* Chiarella v. United States, 445 U.S. 222, 230 (1980) ("[S]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . . But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.").

181. *See* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC Docket 907, 911 (Nov. 8, 1961) ("If . . . disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.").

182. *See, e.g.*, *Chiarella*, 445 U.S. at 231–33 (reversing the insider trading conviction of an employee of a financial printer based on the theory that he used information acquired at work to purchase stock because such a theory would impose a duty upon such persons to the market as a whole).

183. *See* Dirks v. SEC, 463 U.S. 646, 654 (1983) ("In an inside-trading case . . . fraud derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone." (quoting Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 8459, 43 SEC Docket 933, 936 (Nov. 25, 1968))).

when a corporate insider gains an advantage simply from having seen a document or having sat in a meeting at which she learned about a deal before the public did. Because I do not aim to resolve the normative debate about insider trading prohibitions, I will not pursue the question here of how one might justify distinctions between good and bad informational advantages.[184]

Fraud, of course, still requires a theory of deception. Frauds involving nondisclosure typically deceive by taking advantage of a victim's expectations and assumptions. The victim acts on the basis of a reasonable assumption that the undisclosed facts do not exist—for example, a buyer purchases a house assuming the seller would have disclosed a particular defect if it existed. In the case of insider trading, the nondisclosure is deceptive because the counterparty assumes that the trader does not have a particular kind of informational advantage, such as a corporate secret about an upcoming transaction. Or, in the common scenario of highly liquid, faceless markets, the counterparty assumes that the market is relatively free of such traders.

This theory is oddly circular. Why would the counterparty assume that the seller/buyer is not trading on the basis of an informational advantage in the form of nonpublic knowledge acquired as a result of her insider position? Because robust legal prohibitions on insider trading in securities markets now exist, so people are not supposed to do that! The law itself has created the conditions that justify its treatment of insider trading as fraud.

Despite this oddity, the argument for insider trading as a form of fraud has some merit. Fraud is an evolving concept that is contingent on changing social and market norms. Whether conduct is deceptive depends on the expectations that market participants justifiably bring to particular kinds of transactions. People expect disclosure in a lawyer's or investment manager's office, but not necessarily at a used-car lot. At this point, the norm against insider trading is so entrenched in the United States that people are justified in assuming that it is not

184. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658–59 (1997) ("An investor's informational disadvantage vis-á-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill."); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1331, 1373–78 (2009) (arguing that misappropriation cases, in which existing law treats the conduct as fraud on the person or entity from whom the information is improperly acquired and then used, are better treated as cases of fraud on the trading counterparty, due to the unfair advantage gained from the use of information that has been stolen or otherwise improperly obtained).

happening when they go to buy or sell a security—or at least that it is happening infrequently and illegitimately.

Insider trading also works conceptually as a core form of fraud involving purposeful deceit. If the actor has the purpose to deceive when trading on the basis of an illegitimate informational advantage, then she is defrauding her counterparty. If she is merely reckless as to whether she has an illegitimate informational advantage, then she is perhaps misleading her counterparty, but she is not defrauding her counterparty in the core sense of fraud.

It is therefore equally a mistake in the insider trading context as elsewhere in securities fraud to say something like what the Supreme Court said when it stated this rule:

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows *or should know* that there has been a breach.[185]

If one can commit insider trading by merely being careless as to whether one is making improper use of information in a way that misleads one's counterparty, then the legal wrong of insider trading is not a form of core fraud but rather is a form of misrepresentation.[186]

E. Securities Fraud Remains Undefined

This brief tour of positive law yields the conclusion that the delict of securities fraud remains undefined. The cause of action can result in private civil, civil regulatory, or criminal liability. It sounds in law and equity. It can lead to damages, fines, restitution, injunctions, or imprisonment. It can be committed through conduct, statements, omissions, or "devices" and "schemes." It can be pursued with a negligent, reckless, or intentional state of mind.

The law of securities fraud has located itself at expansive points on nearly every one of the axes of fraud with which I began in Part I: (a) acts can include mere conduct or omissions; (b) fault can include forms of negligence; (c) context can include both arm's-length

185. *Dirks*, 463 U.S. at 660 (emphasis added).

186. In *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court strangely added in a footnote that there must be a purpose to defraud and that the issue in the case was not whether the insider or tippee acted with scienter "but rather whether there was any deceptive or fraudulent conduct at all." *Id*. at 663 n.23.

transactions and fiduciary relationships carrying heightened duties of disclosure; (d) sanction can include all forms of civil, equitable, and criminal penalties; and (e) harm can include monetary loss and, at least in SEC and DOJ actions, deprivations of less tangible interests.

Securities fraud is thus a category of legal actions, not a specific form of wrongdoing. In truth, one cannot "commit securities fraud." One can commit any number of transgressions that the law labels "securities fraud." Securities fraud is based not on one conception of fraud but on many available conceptions of fraud. As the next Part explains, continuing to treat this category as if it were a concept—in both doctrine and public discourse—inflicts costs that legal reform can and should ameliorate.

III. IMPROVING THE LAW OF SECURITIES FRAUD

In this final Part, I first ask why anyone should care about what I have demonstrated: that securities fraud is not a single delict but a network of causes of action that have not been sufficiently analyzed independently, only some of which are for core fraud. I argue that the status quo potentially imposes serious costs in the form of a disconnect between the legal regime and its basic regulatory purposes, doctrine that risks criminally sanctioning undeserving actors, and loss of message clarity in the public sanctioning of fraud in financial markets. I then identify and briefly assess some modest options for reform. These take the form of revisions to the statutory and regulatory schemes governing securities fraud and, pending such reforms, a series of helpful moves that the federal judiciary could make in interpreting and applying the existing regime of statutes and rules.

A. *Costs of the Status Quo*

Instrumental analysis dominates this field of law, as it should. Securities regulation is a follow-the-money affair, perhaps all the way down. Insisting on the doctrine's conceptual rigor might thus seem old-fashioned or beside the point. But doing so is instrumentally important. Lack of clarity about what constitutes securities fraud—and whether the conduct identified as securities fraud is even fraud—likely produces three costs.

First, this huge sanctioning machinery is not firmly moored to the purposes of securities regulation. This lack of clarity about the purposes of securities fraud regulation makes achievement or even measurement of optimal deterrence unlikely.

Second, the lack of conceptual distinctions between civil and criminal fraud has produced hazy doctrine on mental state. Criminal sanctions for securities fraud should be reserved for those who deserve the most blame and for those whose conduct calls for the most strongly deterrent of sanctions.

Third, a major disconnect exists between public discourse about financial fraud and what the legal system is doing about it. This gap makes it unlikely that the existing system of public-private regulation can answer important public questions about who has done what in the financial markets, or that it can provide clear instructions to market actors about the distinctions between acceptable and wrongful behavior.

Consider an example that is typical of contemporary discussions in this field. For many years, companies engaged in backdating stock options that had been granted to their employees as compensation.[187] The value of this kind of option compensation is commonly a function of the difference between the price of the company's equity on the date the options are granted and its price on the date employees exercise and sell those options. By choosing, for documentation purposes, grant dates in the past that corresponded with lower market prices than the prices at the actual time of the grant, companies were able to provide stock options that were "in the money" from the start—that is, options that had accrued value even before the employee began the efforts to improve the company's performance that options are, in theory, meant to encourage.[188]

Is the backdating of stock options securities fraud? If so, is it grounds for class action lawsuits, SEC enforcement actions, criminal prosecutions, or all three?[189] Answering these questions intelligibly is

---

187. David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 567–70 (2007).

188. *See id.* at 568 ("[C]ompensatory options vest over time in order to provide retention incentives and incentives to create long-term value.").

189. According to the courts and the executive branch, so far at least, the answer has been "all of the above." *See* United States v. Reyes, 577 F.3d 1069, 1083 (9th Cir. 2009) (affirming a criminal conviction for options backdating); *In re* Juniper Networks, Inc. Sec. Litig., 264 F.R.D. 584, 594–95 (N.D. Cal. 2009) (granting a motion to certify a class action claim challenging options backdating); SEC v. Berry, 580 F. Supp. 2d 911, 912–13 (N.D. Cal. 2008) (reviewing an SEC enforcement action brought against a corporate officer for involvement in an options-backdating scheme); Indictment at 23–40, United States v. Alexander, No. 1:06-CR-00628-NGG-RER (E.D.N.Y. Sept. 20, 2006) (indicting the chief executive officer of a corporation for

possible only with clarity about the nature of securities fraud and its relation to the concept of fraud. In the backdating cases, it would be a fundamental error to say that backdating is fraud because it involves lying about dates or falsifying documents. Contractual arrangements are deemed effective as of handpicked dates all the time—no law prohibits that. Options can be granted "in the money" if a company likes. Corporations can compensate their employees by just handing them cash, or dancing elephants, if they wish.

Determining whether options backdating is fraud requires a careful analysis of the factual circumstances by someone equipped with a clear understanding of fraud. When enforcers and courts set out to do this, one would hope that the law of securities fraud provides them with appropriate and effective tools. A backdating case might turn out to be a fraud, for example, if the company's investors were led to believe that the firm incentivized its employees by granting only contemporaneously dated options and if the company concealed its backdating practices from public view. If one expects an antifraud regime to target culpable conduct, one would also need a relevant actor to have participated in this practice with the requisite degree of mental state.

Without clarity about the nature of securities fraud and its relationship to the concept of fraud, the law is likely to impose sanctions inconsistently. In the case of backdating, sanctions might be imposed without determining whether the problem was, for example, just that some investors were in the dark about backdating or that some corporate managers purposely pulled the wool over investors' eyes by deceiving them about how companies were compensating their employees. Additionally, individuals who have participated in backdating practices may be at greater risk of imprisonment, even if the nature of their participation did not amount to the purposeful deception, committed with a heightened mental state, that would justify criminal sanctions. Finally, the public and even policy elites are likely to be left confused about what backdating is as a financial practice, how serious of a problem it is for corporate governance, and whether it is really fraud.

criminal offenses related to options backdating). *See generally* Steven J. Mintz, *Wave of Lawsuits Follows Stock Options Backdating*, LITIG. NEWS, Jan. 2007, at 1 (describing criminal and SEC enforcement actions targeting the practice of options backdating).

B. Objectives for Reform

1. *Fraud and the Purposes of Securities Regulation*. Unsurprisingly, the same courts that have failed to clarify the relationship between securities fraud and fraud have supplied fuzzy dicta about the purposes of the antifraud regime in securities regulation. If the objective is to deter all material misstatements and misleading conduct in securities markets, the law might impose liability without regard to fault. But if so-called crush-out liability is seen to impose excessive enforcement and potential error costs, the law might raise the standard for liability to negligence. If, however, the objective is to deter actors who seek to craft schemes to profit by deceiving others, the law might impose liability only for core fraud.

In discussing the policies supporting Rule 10b-5, the courts have supplied mostly bromides.[190] To say that the '33 and '34 Acts created a remedial regime designed to deliver transparency in markets and to go beyond the common law of fraud only leaves important questions about the desirable scope of liability unanswered.[191] Assertions about the Acts' purposes tend to appear without much analysis when it is time to broaden the law and rule for the SEC or the plaintiff, just as the importance of discouraging strike suits and attracting capital to markets tends to appear whenever it is time to narrow the law and

---

190. *See* 5B JACOBS, *supra* note 85, § 6:4, at 6-13 ("The sources refer to no less than eight policies underlying [Rule 10b-5]: (1) maintaining free securities markets; (2) equalizing access to information; (3) insuring equal bargaining strength; (4) providing for disclosure; (5) protecting investors; (6) assuring fairness; (7) building investor confidence; and (8) deterring violations while compensating victims."). These constitute an overbroad set of justifications for a rule imposing sanctions for fraud.

191. *See, e.g.*, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 173 (2008) (Stevens, J., dissenting) ("[T]o the extent that 'the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud,' it is because common-law fraud doctrines might be too restrictive." (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 388–89 (1983))); Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) ("Underlying the adoption of extensive disclosure requirements was a legislative philosophy: 'There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.' This Court 'repeatedly has described the fundamental purpose of the Act as implementing a philosophy of full disclosure.'" (citation omitted) (quoting H.R. REP. NO. 73-1383, at 11 (1934); Santa Fe Indus., Inc. v. Green, 430 U.S. 467, 477–78 (1977)) (internal quotation marks omitted)); *Herman*, 459 U.S. at 382 ("[Section] 10(b) is a 'catchall' antifraud provision . . . ."); *id.* at 386–87 ("[W]e have repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.'" (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963))). *But see* SEC v. Zandford, 535 U.S. 813, 820 (2002) ("[T]he statute must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b) . . . .").

rule for the defendant.[192] A regime described merely as remedial and construed liberally to protect investors would, without more guidance, be one that imposed liability for every failure of information delivery.[193]

The American securities laws are a scheme of disclosure regulation,[194] as opposed to one of merit regulation—such as the system for controlling how pharmaceuticals reach the market—or education regulation—such as the system for determining who can practice certain professions. The general idea is to force information into the open to create investment markets that are informationally efficient and protective of investors, and that are therefore more attractive to capital.[195]

---

192. *See* 7 LOSS & SELIGMAN, *supra* note 65, at 3418–20 (exploring the relationship between common-law fraud and securities fraud and stating that the law of securities fraud is meant to be broader in some respects because securities are "intricate merchandise" but that "[h]ow much further the statutes go is difficult to say definitely" (quoting H.R. REP. NO. 73-85, at 8 (1933)) (internal quotation marks omitted)). *Compare Herman*, 459 U.S. at 386 ("The effectiveness of the broad proscription against fraud in § 10(b) would be undermined if its scope were restricted by the existence of an express remedy under § 11."), *with Stoneridge*, 552 U.S. at 165 ("Though it remains the law, the § 10(b) private right should not be extended beyond its present boundaries.").

193. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005) ("[Securities fraud] statutes make [private] actions available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.").

194. *See, e.g.*, Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027, 1039 (1987) ("The establishment of a disclosure-based federal securities regulatory system in 1933 can be described as a rejection of the first indigenous tradition of American securities regulation, the merit-based system prevalent in the midwestern states, in favor of a disclosure-based system derived from a British model and from the broader tradition of Progressive disclosure legislation."). *See generally* LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 89–96 (Melvin I. Urofsky ed., Bedford Books of St. Martin's Press 1995) (1914) ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."); JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 3 (5th ed. 2006) (describing how the federal securities laws were enacted pursuant to "debate on the merits of a mandatory disclosure system" and explaining that the '33 Act "embrace[d]" disclosure as a remedy for the securities abuses of the 1920s); SELIGMAN, *supra* note 85, at 41–57 (recounting the history and context of the adoption of the '33 Act).

195. For differing and nuanced explorations of how securities regulation might achieve some or all of these objectives, see CHOI & PRITCHARD, *supra* note 128, at 22–35; Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 273–97 (2000); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 714 (2006); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1049 (1995); and Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 675 (2002).

An effective disclosure system requires four things: (1) disclosure must be mandatory; (2) mandatorily disclosed information must be understandable, which usually counsels in favor of uniformity; (3) information must be correct; and (4) disclosure must be free of cheating. As with most regulatory systems, sanctions for failing to meet these requirements will generally be necessary to induce compliance in each area.

Assuming the substance of what investors need to know is correctly determined, the first three elements of an effective disclosure regime are fairly straightforward. Rules must specify what information has to be disclosed and must clarify that failures to disclose may result in sanctions.[196] Those rules must further specify a uniform method of disclosure that makes disclosed information understandable with minimum effort and expense. And to induce disclosers to take care that information is correct, sanctions must be imposed for disclosure of inaccurate information.[197]

The fourth element of an effective disclosure regime is a somewhat more complex matter. One might argue that it is unnecessary: sanctions for inaccurate disclosure are sufficient to ensure that disclosed information is reliable; the further question of whether inaccuracy was the product of venal actions is not relevant. But that is decidedly not the conclusion reached by the architects of the American system of securities regulation or their legislative, administrative, and judicial successors.

A pillar of American securities regulation has been the belief that a failure to sanction fraud severely will induce investors to flee for the exits.[198] Economists call this concern a "lemons market."[199] The

196. Forcing actors to state things on the record may also make them more careful about telling the truth. *See* Fox, *supra* note 195, at 258 ("[T]he habit of engaging in a wide range of required disclosures may make it harder for a manager to rationalize breaking the disclosure regulations than to rationalize entering into a questionable transaction that the manager persuades himself is good for the corporation as well as himself.").

197. *See, e.g.*, Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m(b) (2006) (requiring public companies to record and disclose information, authorizing the SEC to issue disclosure rules, and sanctioning violations of disclosure requirements); *see also* Klass, *supra* note 119, at 45 (discussing why in some contexts, regulatory systems might justifiably impose liability for misrepresentations made carelessly or without fault).

198. *See* Rock, *supra* note 195, at 686 ("[T]he public and private enforcement machinery of the securities laws and the combination of criminal and civil liability makes securities disclosures far more credible than purely contractual representations.").

199. CHOI & PRITCHARD, *supra* note 128, at 24 (explaining how a lemons market can develop from a failure to make honest disclosures); Goshen & Parchomovsky, *supra* note 195, at 762 n.192 ("A 'lemons market' is a market in which asymmetric information exists between

original drafters of the law of securities fraud expressed it as a concern about cheating in the stock markets.[200] The perceived need for reform in the 1930s arose not just from the fact that investors could not get a full view of what was going on but also that they were highly vulnerable to being cheated—and that they had learned of this vulnerability in the never-to-be-forgotten crash.[201]

If the purpose of imposing liability for securities fraud is to supply material incentives for accuracy in disclosure, then maybe the law should impose liability for merely negligent misrepresentations, or perhaps even strict liability for all material inaccuracies.[202] But why would the law call all violations of such a regime "securities fraud," and why would the statutory system combine disclosure mistakes and schemes designed to cheat investors under a single liability umbrella? I can think of no good explanation other than the path dependency that has characterized the development of the law under Rule 10b-5.

If the purpose of imposing liability for securities fraud is, by contrast, to warrant to investors that markets are reasonably free of cheating, then one would expect sanctions to be limited to cases of core fraud, involving purposeful deception—and perhaps also to cases of conscious recklessness under some circumstances. But nothing more.

Deterrence analysis is more complex than this, of course. One has to take many features into account, including enforcement costs, error rates, whether liability standards function well as an evidentiary

---

sellers and buyers. Since the buyers are not fully informed as to the quality of the products, they discount the price of all products.").

200. *See generally* MICHAEL PERINO, THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA'S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE (2010) (recounting the congressional investigation into the causes of the 1929 stock-market crash and related unfair practices on Wall Street).

201. Milich, *supra* note 28, at 182 ("The primary issue under the statutory scheme is not whether someone was harmed but whether someone was cheated. The aim of [Section 10(b) of the '34 Act] is not to enforce competency in the securities markets, but honesty.").

202. *See* Cox, *supra* note 28, at 571–88 (arguing for interpreting Rule 10b-5 as imposing liability for negligent conduct and stating that "[t]he ultimate concern in [the *Hochfelder* case] should have been whether a negligence standard would fulfill the objectives of the federal securities laws of assuring the flow of complete, accurate information to investors without imposing an unreasonable burden upon the conduct of business"); Goshen & Parchomovsky, *supra* note 195, at 777–80 (arguing that negligence might be the appropriate fault standard in cases of securities fraud because, among other reasons, it would reduce litigation costs and cause managers to take greater care to verify the accuracy of disclosures); *id.* at 780 (asserting, somewhat daringly, that "[t]he high-scienter standard of review achieves an efficient balance because the agency cost problems embodied in the class action mechanism ensure that the actual standard will slide to the appropriate level—negligence" (footnote omitted)).

matter, institutional problems such as regulatory capture, agency costs of class action attorneys, and so on. To get all the relevant considerations working together in a single analysis is a Herculean task.

My point in this Article is simply that the United States has a liability regime that has been permitted largely to duck the question of its purpose within the scheme of securities regulation. Legal actors constantly talk about the practice of sanctioning securities fraud as if its purpose were the pursuit of deception in markets. But the law itself sanctions many forms of disclosure failure. And enforcement practices usually fail to distinguish among which kinds of disclosure failure are being pursued.

Even if nothing were to be changed about the law of securities fraud, the system would profit from a more explicit conversation about whether the purposes of the regime of securities regulation counsel in favor of sanctions only for core fraud, for all disclosure failures, or for some combination of the two—and about whether sanctioning those various behaviors under a single liability rule makes sense. Even the academic literature has come to talk about securities fraud as if it were a single thing with a well-understood meaning, without sufficient discussion of the layered features of this body of law or its nebulous and unspecified relationship to the concept of fraud.

2. *The Civil-Criminal Line*. On the one hand, I have supplied dozens of citations to federal appellate decisions that reflect and approve a state of affairs in which juries are told that they may criminally convict for fraud if they find that a defendant acted with reckless disregard to the truth of her representations. On the other hand, as a former federal prosecutor, it was my experience that assistant U.S. attorneys, who are generally risk averse, were not attracted to the idea of bringing white-collar-crime prosecutions in the absence of good evidence of a defendant's intentional wrongdoing. The more typical pattern was to decide to indict the case only after the investigation had turned up damning evidence of culpability, and then to ask the trial judge to instruct the jury in a manner likely to ease the path to conviction. Thus, one cannot know how many criminal securities fraud convictions involve defendants who had no more than a reckless state of mind—in either the conscious-disregard or the super-negligence sense of the term.

Securities fraud is not manslaughter. The Anglo-American legal system generally does not impose particularly condemnatory forms of criminal liability on reckless actors who do not commit violent offenses.[203] Some commentators have argued that the disregard of others' interests involved in recklessness—in the conscious-disregard sense of the concept—is a sufficient measure of blameworthiness to serve as a general justification for criminal fault.[204]

But that is not a view that has held sway in the law of serious nonviolent crimes in the United States. White-collar and economic offenses like obstruction of justice, fraud, bribery, extortion, and the like have generally been defined as requiring some form of specific intent. Unlike violent crimes, such cases typically raise the question whether acts that have ambiguous meaning are made criminal by the purpose or goal behind them.[205] For instance, not all thwarting of the legal process is wrongly motivated obstruction. Not all deception in markets is fraud. Not all financial dealings with public officials are bribery. Not all coercive behavior is extortion.

Because only a mens rea inquiry can separate the malign from the benign in many such instances, that inquiry must be exacting enough to bear the full weight of the criminal process. In the context of securities fraud—in which the enforcement system is selecting and identifying bad actors in markets that are vital to the American economic engine—insisting that the standard for criminal fault be both high and clear and that it be closely tethered to a conception of genuine core fraud seems uncontroversial.

3. *Capitalizing on Expressive Capital.* The idea of fraud has been centrally important to public discourse about the economy, and never more so than in the wake of the largest cataclysm in the markets since the Great Depression. The law of securities fraud is the 800-pound gorilla of antifraud law. When lawyers call something securities fraud, especially when referencing a high-profile case, they are shaping the social conception of fraud. Fraud not only constitutes legal doctrine, it also has an expressive power that can determine norms and

---

203. For a different view, see Seigel, *supra* note 28, at 1613.

204. *See, e.g.*, LARRY ALEXANDER & KIMBERLY KESSLER FERZAN, CRIME AND CULPABILITY: A THEORY OF CRIMINAL LAW 23–68 (2009) (examining recklessness as a basis for criminal liability).

205. *See* GREEN, *supra* note 30, at 30–47 (contrasting determinations of mens rea, harmfulness, and moral wrongfulness in the context of conventional crime versus white-collar crime).

behavior.[206] That expressive force flows, in complex fashion, from both the doctrine and the public discourse about fraud. Such a potent instrument should be maintained carefully.

It is my general impression that many who manage firms, represent them, investigate them, sue and prosecute them, and report on their affairs also believe that prominent cases of public enforcement have a major impact on understandings of and attitudes toward fraud. But empirical evidence of such a dynamic, or the lack thereof, would be difficult to extract from the complex social and economic web in which actors form beliefs about which behaviors are seriously wrong and how the legal system treats those behaviors.[207]

Professor Donald Langevoort argues that Rule 10b-5's fluid quality—its "wobble"—has been a virtue because American society's understanding of the relationship between investors and markets is both evolving and suffused with shortages of empirical information.[208] According to Langevoort, the malleable law of securities fraud has

---

206. *See* Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503, 1511 (2000) ("[E]xpressive norms regulate actions . . . ."); Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 519 (2006) ("[Expressive theorists] have asserted that the imposition of . . . criminal liability expresses important values even if it cannot inflict sanctions that differ materially from civil penalties."); Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 352 (1997) ("[I]f the expressive significance of one form of punishment (say, imprisonment) more effectively expresses community disapprobation than does another one (say, fines or community service), the effect of the former in directing social influence may justify selecting it even if the latter imposes the same price on crime at a lesser social cost."); Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339, 340 (2000) ("Because people are motivated to gain approval and avoid disapproval, the information signaled by legislation and other law affects their behavior."); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2025 (1996) (exploring "how legal 'statements' might be designed to change social norms"). *But see* Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363, 1364 (2000) (arguing that expressive theories of law, properly understood, are not persuasive).

207. It is suggestive, however, that there is clear evidence that initial media reports of fraud affect the market's assessment of a firm's value long before legal proceedings resolve the question of liability. *See, e.g.*, Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021, 1047–50 (2007) (finding that investor outflow is greater when a scandal that harms investors is first discovered by the press rather than the SEC); Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANT. ANALYSIS 581, 582 (2008) (arguing that financial penalties imposed by courts for misconduct are far outweighed by the financial impact of reputational losses suffered because of the misconduct).

208. Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 FORDHAM L. REV. S7, S7–S8, S16–S19 (1993) (arguing that the adaptability of Rule 10b-5 is a virtue "because we as a culture have not yet created a consistent, persuasive story of what the business of investing is all about").

been able to adapt to changes in attitude and to avoid deciding certain difficult questions, thereby protecting the "crown jewel" of securities regulation from the violence it might endure were it subject to searching examination and revision.[209]

Professor Langevoort has a point, but not a very uplifting one. This field of law continues to bear more and more weight in both financial regulation and public discourse, while avoiding scrutiny as to what makes it worthy of such load bearing. How long can the illusion that Rule 10b-5 really decides questions of fraud last, and why should lawyers permit that illusion to persist? Saying that a legal regime is effective in part because it successfully avoids taking a clear position on what it is doing has more than a hint of circularity.

I began the discussion of fraud in Part I by pointing to three competing demands that the law must manage: the need for adaptability in the face of innovation, the requirements of adequate notice and fairness that emanate from legality-related values, and the need to preserve the concept of fraud as an idea that Americans use to organize legal and public discourse about wrongdoing in financial affairs and to sort out what has happened when markets go wrong.

Every time a market bubble bursts, or even strongly corrects, a large class of losers inevitably claim to be the victims of fraud because they have lost heavily after believing things that turned out to be false. The more harm done, the more these victims also become angry with the sellers in the market for creating the bubble—especially if many of the same sellers hedged themselves or exited the market before the crash—and want to see them severely punished.

If the law gives most, or even many, of those harmed a cause of action to recover their losses on the basis of fraud, if the law permits imprisonment of such persons, and if prosecutors act primarily to satisfy public appetites, the idea of fraud will gradually lose its meaning. The end result could easily be that fraud is equated with nothing more than legal outcomes or political power. Meanwhile, the ability to identify instances of seriously culpable wrongdoing from among the great mass of all market failings would be lost. To condemn everyone is, ultimately, to condemn no one. This has long

209. *Id.* at S19 (discussing the reasons that Rule 10b-5 is unlikely to be revised, such as a "fear of opening up the enforcement 'crown jewel' of securities regulation to the vagaries and special interests of the political process" (footnote omitted)).

been a worry within particular areas of the criminal law.[210] And depletion of criminal law's moral authority is even more concerning in areas of law that bridge criminal and civil liability.[211]

If one cares about preserving the expressive force of the concept of fraud, one should want to reserve fraud doctrine for serious wrongs. That might include limiting liability for securities fraud to cases of purposeful deception or its near equivalent. At the least, one should want to insist on clarity about what the law means when it talks about fraud.

C. Reform Angles

To complete this Article, I sketch two angles, which are not mutually exclusive, for reforming the law of securities fraud in service of the agenda advocated in the previous Parts.

1. *Amend the Statutes and Rules*. Much of my argument has been directed at the need for a more explicit discussion of the purposes of Rule 10b-5 and related aspects of securities regulation and of the question of what types of fraud and misrepresentation ought to be sanctioned. Suppose for a moment that the discussion ended up at more or less the status quo: The law of securities fraud ought to sanction both core fraud and misleading statements and conduct committed with gross negligence or even simple negligence. And it should include both civil and criminal penalties.

Reform would still be in order, so that securities law could be much clearer about what forms of fraud and misrepresentation it means to sanction and why, about what form of conduct it is sanctioning in any particular instance, and about why the particular form of sanction chosen fits the conduct in a given case. Even in litigation environments in which settlement is the overwhelming

---

210. *See* Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 431 (1958) ("What sense does it make to insist upon procedural safeguards in criminal prosecutions if anything whatever can be made a crime in the first place? What sense does it make to prohibit ex post facto laws (to take the one explicit guarantee of the Federal Constitution on the substantive side) if a man can, in any event, be convicted of an infamous crime for inadvertent violation of a prior law of the existence of which he had no reason to know and which he had no reason to believe he was violating, even if he had known of its existence?").

211. John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 200 (1991) ("[T]he criminal sanction is increasingly being used by regulators as a preferred enforcement tool without regard to the traditional limitations on its use.").

norm, such changes would discipline the pleading and settlement processes in ways that would channel case selection and improve the clarity of deterrent and educative messages.

Some simple redrafting could go a long way in this regard. One might reorganize both Section 17 of the '33 Act and Rule 10b-5 into separate provisions: one for core fraud, using something like the "any scheme to defraud" language, and one for misrepresentations, using language like "misrepresentation or conduct or omission that misleads." Thereafter, the law would provide causes of action for "securities fraud" as well as causes of actions for "misrepresentation in securities transactions."

Next, one might add language specifying the levels of mental state or fault applicable to each cause of action. The statutes and rules should state that liability for securities fraud attaches only upon proof of a purpose to deceive. Depending on the degree to which normative considerations counsel for or against crush-out liability for misstatements in securities markets, liability for misrepresentations would attach upon proof of recklessness, explicitly defined in either the conscious-disregard or super-negligence sense; negligence; or even no-fault, strict liability. If liability were permitted for simple negligence or for faultless violations, one might consider calling the cause of action "disclosure failure" rather than "fraud" or "misrepresentation."[212] Further distinctions at the sanctioning stage—guidelines for the amount of fines, for example—would be advisable to achieve the desired levels of deterrence of intentional fraud versus deterrence of misrepresentations committed recklessly or with even less fault. Such distinctions would also create a clear system of graded and escalating sanctions for more serious violations.[213]

212. Whether—or how—the D&O insurance market might adjust, if at all, were the law of securities fraud to clearly distinguish cases of intentional fraud from cases of careless misrepresentation is an interesting question, but that question is beyond the scope of this Article.

213. The single comprehensive redrafting exercise since adoption of the securities laws—the American Law Institute's proposal of a never-adopted Federal Securities Code—did not suggest changing the existing law by dividing fraud and misrepresentation or distinguishing among levels of awareness. *See* FED. SEC. CODE §§ 202(61), 202(86), 202(96), 202(147), 1602, 1604 (Proposed Official Draft 1978). A House bill preceding enactment of the PSLRA did propose that in private lawsuits, securities fraud could only be established with proof of both intent to deceive and knowledge of falsity or recklessness as to falsity, which was explicitly defined in the gross-negligence sense. H.R. 1058, 104th Cong. § 4 (as passed by House, Mar. 10, 1995). The proposal was not enacted.

Finally, criminal liability would attach only for core fraud, not for misrepresentation, and the "willful[ness]" requirement for criminal penalties would be defined. The government might be required to prove that a defendant acted not just with the specific intent to defraud but also with awareness that her conduct was wrongful.[214] Provided that this mens rea requirement is satisfied, the law might also specify that she could be criminally liable for acting with willful blindness or a conscious disregard of a substantial risk that her representations were false or that her conduct or omission was misleading.

As straightforward as such a drafting exercise might be for lawyers, it would face severe political obstacles. The battle over the PSLRA was one of the great lobbying and legislative clashes of the Clinton administration.[215] And that legislation did almost nothing with regard to the substantive liability standards involved in securities fraud. Indeed, one suggestion to change the underlying law was rejected because agreement was thought to be impossible.[216] Talk of legislation to respond to one of the Supreme Court's most recent decisions on the substantive law of securities fraud also has gone nowhere.[217]

---

214. *See* Beveridge, *supra* note 28, at 47 ("[T]he U.S. Supreme Court had, just months before passage of the 1934 Act, held that when the word 'willful' is used in a penal statute, it generally means an act done with a 'bad purpose,' not merely an act which is knowing, or voluntary, as distinguished from accidental.").

215. *See* John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 335 (1995) ("On December 22, 1995, the U.S. Senate voted to override President Clinton's veto of [the PSLRA], concluding a long and often rancorous legislative effort to bring about a sweeping revision of both substantive and procedural law governing private actions under the federal securities laws."); Brian S. Sommer, *The PSLRA Decade of Decadence: Improving Balance in the Private Securities Litigation Arena with a Screening Panel Approach*, 44 WASHBURN L.J. 413, 413 (2005) ("Notwithstanding debate, controversy, and a presidential veto, the United States Congress enacted [the PLSRA] in December of 1995.").

216. *See* Avery, *supra* note 215, at 337 ("Congress appears studiously to have avoided the question of whether recklessness is sufficient for private liability under the antifraud provisions of the Securities Exchange Act of 1934 . . . .").

217. *See* 156 CONG. REC. S3569, S3618 (daily ed. May 12, 2010) (introducing legislation amending the '34 Act to allow private actions against aiders and abettors); *see also* 156 CONG. REC. S3663, S3670 (daily ed. May 13, 2010) (discussing the reasons for amending the '34 Act); 156 CONG. REC. S3385, S3399–S3400 (daily ed. May 7, 2010) (same). Congress did not pass the proposal, instead directing "a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929Z, 124 Stat. 1376, 1871 (2010).

It might seem politically fraught to reopen a discussion on first principles that has been largely dormant since SEC Commissioner Sumner Pike famously declared seventy years ago: "[W]e are against fraud, aren't we?"[218] But perhaps inertia can be overcome. A settling academic consensus argues that the fraud-on-the-market class action lawsuit under Rule 10b-5 is, at least in its current form, unjustifiable.[219] This relatively recent trend highlights an instability in the law of securities fraud that can only increase and that this Article has sought to expose further.

2. *Repair the Doctrine in the Courts*. Federal courts have exceptional latitude with the law of securities fraud. Even given the increasing skepticism in the political arena about judge-made law, the role of the courts in gap-filling the law of securities fraud is so well accepted as to be a ready vehicle for reforming that law. Absent congressional intervention in the law of securities fraud, courts cannot avoid their role as authors of the law. Perhaps matters would be improved if judges were somewhat more candid about that role.

Four relatively simple steps on the road to reform are readily available to the judiciary. First, the courts should stop talking about securities fraud as if it were one thing. Rule 10b-5 and Section 17 each plainly cover both core fraud and other forms of misrepresentation and misleading conduct. When discussing securities cases, whether civil or criminal, courts should require precision in the moving party's theory about what types of conduct are alleged to have violated the law. Developing a practice of talking about "securities fraud" and "misrepresentation in connection with securities transactions" as two separate things would require only a small further step. And such a practice would communicate more clearly to the public what exactly is being sanctioned by the state under the label "securities fraud."

There is concededly an argument for recklessness coexisting with a core conception of fraud. If an actor intends to deceive and, in furtherance of that goal, makes a conscious choice to disregard a substantial risk that what she is saying is false or that what she is doing is likely to deceive, she may be just as blameworthy as the purposeful actor who has full knowledge of her representation's

218. 5B JACOBS, *supra* note 85, § 6:3, at 6-10 (quoting Milton Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967)) (internal quotation marks omitted).

219. William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market* 5 (Univ. of Pa. Inst. for Law & Econ., Research Paper No. 11-17, 2011), *available at* http://ssrn.com/abstract=1824324.

falsity. The speaker who chooses to make a representation knowing it *may* be false has something equivalent to knowledge of falsity: she knows that she does not have the confidence in what she is saying that her assertion implies.[220]

But the law of private liability for securities fraud has not even attempted to engage with this argument. Federal courts—especially the Supreme Court—have badly elided distinctions among intent, knowledge, recklessness, and negligence, as well as between an actor's goals and her state of mind with respect to the tendency of her words or conduct to mislead. The result is that the private right of action under Rule 10b-5 has become both an action for sanctioning—through heavy class action damages—intentional deceivers in the securities markets and for compensating persons who have suffered loss as a result of being misled through others' gross carelessness.

Second, the courts should be clearer about mental state and fault. The rule and statutes are essentially silent on the matter. The concept of fraud and the nature of the underlying wrongdoing involved in securities cases pivot on the state of mind with which the violator acts. The matter of an actor's purpose—her specific intent to defraud—should be clearly distinguished from the matter of her degree of fault with respect to the falsity of her representation or the tendency of her conduct or omission to mislead. Judges should stop talking about scienter, intent to defraud, and recklessness as if these mental-state concepts can substitute for each other.

Third, on the matter of an actor's awareness or fault with regard to the falsity of her statement or the tendency of her conduct or omission to mislead, courts should clearly distinguish negligence from recklessness. Within recklessness, courts should also distinguish between conscious disregard of a risk of falsity versus extreme lack of care with regard to falsity. Although the law may be justified in treating varying knowledge states as producing the same legal consequences, judges should also clearly distinguish three knowledge

---

220. *Cf.* United States v. Sheiner, 273 F. Supp. 977, 982–83 (S.D.N.Y. 1967) ("If the defendants' acts were done inadvertently, mistakenly, or in good faith without an intention to defraud, then . . . the defendants must be acquitted. . . . On the other hand, if the defendants acted wilfully and purposely with an evil intent, *or with a reckless indifference to the truth*, then they are chargeable with the requisite knowledge and criminal intent." (emphasis added)), *aff'd*, 410 F.2d 337 (2d Cir. 1969). A poor argument, however, is to say, in a bootstrap maneuver, that "one who acts with reckless indifference to whether a representation is true or false is chargeable with knowledge of its falsity." United States v. Beecroft, 608 F.2d 753, 757 (9th Cir. 1979).

states from each other: actual awareness of falsity, willful blindness as to falsity, and conscious-disregard of a substantial risk of falsity. Above all, criminal fraudulent intent should be distinguished from forms of scienter that are deemed sufficient for civil liability.

Fourth, courts should do more work to clarify the conditions in which nondisclosure and conduct can support liability for securities fraud. And they should draw a tighter connection between the axes of conduct and context and the axis of fault. The conclusion might well be that, even in a relationship in which certain conduct or omissions are deceptive, securities fraud liability for such conduct or such omissions requires a purpose to deceive and cannot be imposed when an actor simply behaves negligently or recklessly.

CONCLUSION

For all the discussions of the instrumental effects of liability for securities fraud—and even of related, subsidiary questions about the doctrine surrounding reliance, loss causation, and fraud on the market—we have neglected the matter at the core: the wrong of fraud itself. The chief doctrinal question is the matter of mental state and fault or, as the field terms it, scienter. But the real questions are what fraud is as a concept and which conception of fraud the world's most powerful body of antifraud law is pursuing. Neglect of the conceptual choices underlying fraud is far from the only problem in the field of securities fraud, but it is exceedingly important.

Sustained attention to this matter promises to deliver three things that would make the law of securities fraud a better public servant: clarity about whether the mission of the securities fraud liability regime is to deter cheating in the markets or, much more broadly, to ensure accuracy in disclosure; ability better to warn those who may land in prison for this kind of conduct and to explain why those who land there belong there; and power to answer more decisively prominent public questions about what has been done by whom when firms and markets go badly awry.