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**SEC REVANCHISM AND THE EXPANSION OF PRIMARY
LIABILITY UNDER SECTION 17(a) AND RULE 10b-5**

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INTRODUCTION

An exceedingly important question for those facing the possibility of fraud charges in an enforcement case brought by the Securities and Exchange Commission is the scope of primary liability under the two main anti-fraud provisions, Section 17(a) of the Securities Act and Rule 10b-5 of the Securities Exchange Act.¹ That subject has received close attention from the Supreme Court and lower courts, and recently the SEC weighed in with a survey of each of the subparts of Section 17(a) and Rule 10b-5 in a decision in an administrative adjudication of enforcement charges.²

¹ 15 U.S.C. §§ 77q(a), 78j(b); 17 C.F.R. § 240.10b-5.

² In an adjudication, see 5 U.S.C. §§ 551(7), 554; text and accompanying note 191 *infra*, the SEC Commissioners function as a court. Earlier the SEC had charged two indi-

In the *Flannery* decision,³ a bare majority of Commissioners staked out broad positions on primary liability under Rule 10b-5(a) and (c) and Section 17(a)(1), (2), and (3), as described in Part I below. The Commission not only advanced expansive legal conclusions, but it also insisted that the courts accept the agency's legal interpretations as controlling.

The SEC's decision in *Flannery* raises thought-provoking issues about the role of administrative agencies in the development, enforcement, and adjudication of federal law. The purpose of this article is to discuss two of those issues.

The first concerns the consistency of *Flannery* with the Supreme Court and lower court decisions defining the scope of primary liability under Rule 10b-5 and Section 17(a). This article explains that much about *Flannery* is not consistent with, and is antagonistic to, a series of prominent Supreme Court decisions that imposed meaningful boundaries around aspects of primary liability under Rule 10b-5. Those decisions are *Central Bank of Denver, NA v. First Interstate Bank of Denver, NA*,⁴ *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,⁵ and *Janus Capital Group, Inc. v. First Derivative Traders*.⁶

The Commission in *Flannery* sought to confine and distinguish those precedents, but Part II.A below questions the SEC's reading of the cases and explores the reasoning and analysis in *Stoneridge* and *Janus* to determine whether the opinions were, as the Commission said, limited solely to the reliance element in private cases or to subpart (b) of Rule 10b-5. That review reveals that the effort of the Supreme Court in the cases was to draw a crisper line between primary liability and aiding and abetting and to define a primary violator as the separate and independent person with final control and authority over the content and use of a communication to the investing public. The Court's rationales ran to both Rule 10b-5 and Section 17(a).

Part II.B then compares the reasoning and analysis in the Supreme Court cases plus a selection of court of appeals decisions with the Commission's approach in *Flannery*. One point of comparison is that the Commission used a loose and unprincipled policy of interpreting the laws flexibly to achieve their remedial purpose. The Supreme Court long ago dis-

viduals with violations of Section 17(a) and Rule 10b-5 and sent the case to an administrative law judge for initial resolution.

³ *Flannery*, SEC Release No. 3981, 2014 WL 7145625 (Dec. 15, 2014). Chair White and Commissioners Aguilar and Stein were in the majority. Commissioners Gallagher and Piwowar dissented without a separate opinion. Citations will be to "*Flannery*" with the Westlaw page number.

⁴ 511 U.S. 164 (1994).

⁵ 552 U.S. 148 (2008).

⁶ 131 S. Ct. 2296 (2011).

credited and refused to apply that policy, but *Flannery* wielded it repeatedly to reach outcomes that grossly exceed the boundaries the Court appeared to be setting in *Stoneridge* and *Janus*.

For example, the Commission would extend primary liability to a person who orchestrated a sham transaction designed to give the false appearance of business operations even if a material misstatement by another person creates the nexus between the scheme and the securities market.⁷ According to the Commission, Section 17(a)(1) goes further and covers a person who entered into a legitimate, non-deceptive transaction with a reporting company but who knew that the public company planned to misstate the revenue.⁸ These constructions disregarded the lesson of *Stoneridge*. A person entering into a transaction with a public company, even a deceptive transaction, that resulted in the public company's disclosure of false financial statements did not have primary liability when the public company was independent and had final say about its disclosures. The Commission would extend primary liability to a person who drafted, approved, or did not change a disclosure made by another,⁹ but *Janus* held that a person working on a public disclosure was not the primary actor when another independent person issued and had final say about the disclosure.

A reading of the *Flannery* decision leaves the definite impression that a majority of SEC Commissioners aimed to use the case as a vehicle to recover much of the territory lost in the enforcement area from the Supreme Court decisions and the lower federal courts that have been following the Supreme Court's lead. It was an effort to supersede the court judgments by re-interpreting and extending the prohibitions in Rule 10b-5 and Section 17(a). If these concerns have merit, the actions of the SEC, an administrative agency within the Executive Branch, are unsettling. They take the *stare* out of *stare decisis*, rattle the stability of legal rules, upset traditional expectations about the role of the courts in the development of the law, and head toward a society ruled by bureaucratic fiat rather than ordered by laws.

The second issue discussed in this article is whether the courts must or should treat the SEC's legal conclusions in an adjudication as controlling under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*¹⁰ *Flannery* included an overt claim to *Chevron* deference.¹¹ Part III evaluates this bid for *Chevron* deference and concludes that the courts would have doctrinal and precedential grounds for refusing to accept the

⁷ *Flannery* *12.

⁸ *Id.* *16 n.86, *17-*18.

⁹ *Id.* *12, *24.

¹⁰ 467 U.S. 837 (1984).

¹¹ *Flannery* *9.

Flannery positions as controlling. Part III.C goes through these reasons, starting with the text of the provision of the Administrative Procedure Act governing judicial review of agency actions and looking closely at the actual practice of the Supreme Court and courts of appeals when they review a legal conclusion in an agency adjudication. Part III.E discusses particular features about *Flannery* that would justify a reviewing court in not giving controlling weight to the interpretations of Rule 10b-5 and Section 17(a).

The precedents identify good reasons for not granting *Chevron* deference to *Flannery* or similar agency adjudications in enforcement cases. Giving controlling effect to the SEC's decision in *Flannery* would allow the agency both to avoid the teachings of leading Supreme Court authorities and to trump the Supreme Court and other federal courts on significant matters of statutory interpretation. It would empower the SEC to cut short and silence the normal process in the federal courts for testing and establishing the limits of liability provisions, and it would enable the SEC to tip the scales in enforcement cases by converting its litigating positions into non-reviewable legal interpretations. The cumulative effect of an agency's decision to roll back Supreme Court precedent and to consolidate for itself ultimate decision-making power over questions of law traditionally left to the courts would seriously alter a balance between agencies and courts long recognized in our system of government.

These two issues are not the only topics of interest in *Flannery*. The Commission opinion raises many more. Chief among them are the proper interpretations and coverage of each of the sub-parts of Section 17(a) and Rule 10b-5. That was the main subject of *Flannery*, and it deserves careful study and analysis by courts, practitioners, and scholars. The purpose of this article is not to propose conclusions on that important set of questions, although the discussion in Part II below will suggest some considerations and limitations that should bear on an appropriate construction of the statute and Rule.

Flannery touches on other points that are beyond the scope of this article. For example, the Commission majority suggested that the SEC does not need to prove either negligence or scienter for a violation of Section 17(a)(2) or (3). Strict liability might exist, even though courts of appeals require the Commission to prove negligence.¹² Another example is

¹² *Aaron* held that scienter is not an element of a claim under Section 17(a)(2) or (3). *Aaron v. SEC*, 446 U.S. 680, 697 (1980). Justice Blackmun's separate opinion assumed negligence would need to be proved. *Id.* at 703, 715 (Blackmun, J., concurring in part and dissenting in part). The *Flannery* opinion said "the Court has never addressed whether negligence is *necessary* to prove a violation of those provisions" and pointed out that the Supreme Court said the focus of Section 17(a)(3) is on the effect of particular conduct on members of the investing public. *Flannery* *10 n.30 (italics in original). The Commission suggestion of the possibility of strict liability for a violation of Section 17(a)(2) or (3) is contrary to the law in those circuits that require proof of negligence. See *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1244 (11th Cir. 2012) (under Section

the Commission's position that Section 17(a)(3) prohibits pure omissions without a corresponding duty to disclose.¹³ A third issue that deserves more attention is the Commission's view that it could use a section of the Dodd-Frank Act to impose a monetary penalty in an administrative proceeding for conduct occurring before the enactment of the Dodd-Frank Act.¹⁴ All in all, *Flannery* provides much fodder for rumination by the bench, bar, and academy.

I. **THE *FLANNERY* CASE AND THE COMMISSION'S INTERPRETATIONS OF THE SUBPARTS OF RULE 10b-5 AND SECTION 17(a).**

A. **Background.**

The case was about disclosures describing the securities in the portfolio of a fixed income investment fund called the Limited Duration Bond Fund. State Street Bank and Trust Company formed and administered the Fund and acted as the investment adviser.¹⁵

The Commission found that the Fund's promotional materials in 2006 and 2007, such as quarterly fact sheets and presentations or letters to current and potential investors, contained misleading statements about the Fund's exposure to subprime residential mortgage-backed securities. Many investors believed that the Fund had little or no exposure to subprime investments when the subprime turmoil commenced in 2007. In

17(a)(2) or (3) a material misrepresentation must be "made with negligence"); *Weiss v. SEC*, 468 F.3d 849, 855, 856 (D.C. Cir. 2006) (*Weiss* failed to take steps necessary to support statements in a legal opinion); *SEC v. Ficken*, 546 F.3d 45, 47, 52 (1st Cir. 2008) (referring to the "negligence requirement" of Section 17(a)(2) and (3)). Some appellate courts say negligence suffices, but they mean proof of negligence is needed and proof of scienter is not. See also Matthew Martens et al., "We Intend to Resolve the Ambiguities": The SEC Issues Some Surprising Guidance on Fraud Liability in the Wake of *Janus*, 47 *Sec. Reg. & L. Rep.* 220, at 5 & n.65 (February 2, 2015).

¹³ *Flannery* *18 & n.101 (Section 17(a)(3) might apply when, "as a result of a defendant's negligence, prospective investors are prevented from learning material information about a securities offering."). See text accompanying notes 190 *infra*.

¹⁴ In a passage not necessary to the outcome, the Commission said the section of the Dodd-Frank Act permitting the Commission to impose a monetary penalty in any administrative cease and desist proceeding, now in 15 U.S.C. §§ 77h-1(g), 78u-2(a)(2), does not have impermissible retroactive effect because the Commission could have sued the defendant in federal court and obtained a monetary penalty. The Dodd-Frank Act addition was forum-shifting legislation that may be applied to pre-enactment conduct. *Flannery* *40 n.201.

¹⁵ State Street was not a registered investment adviser, relying on an exclusion of banks from the definition of investment adviser in section 202(a)(11) of the Investment Advisers Act. The Fund was not a registered investment company, relying on an exclusion from the definition of investment company under section 3(c)(11) of the Investment Company Act. See *Flannery*, SEC Release No. ID-438, 2011 WL 5130058, at *2 (ALJ October 28, 2011). Citations will be to "Initial Decision" with the Westlaw page number.

fact, the portfolio was over 80 percent invested in subprime residential mortgage-backed securities in June 2007.¹⁶

Beginning in the middle of June 2007, the market for subprime investments was in crisis, and the value of the Fund steeply declined. Investors in the Fund suffered significant losses.¹⁷

Flannery and Hopkins worked for State Street and communicated directly with investors and potential investors in the Fund. They also worked on State Street materials or letters communicated to current or potential investors.

Several particular investor communications were important in the case. One was a page of a slide presentation. State Street used a standard presentation of slides when presenting information about the Fund to clients and prospective clients. From September 2006 through June 2007, Hopkins used the standard presentation in many meetings with current and prospective investors about the Fund. One slide presented a breakdown of the Fund's "typical" portfolio by sector, stating, in relevant part, that the Fund was only 55 percent invested in asset backed securities. The Fund was actually more invested in ABS: over 85 percent at the end of 2006, 100 percent at the end of March 2007, and over 80 percent at the end of June 2007.¹⁸ Two other communications discussed in the case were letters to investors in August 2007. One letter described steps State Street had taken to reduce risk in the Fund portfolio, and the other implied that investors were not redeeming ownership in the Fund. Flannery contributed to the letters. The Commission found that all three were materially misleading.¹⁹

On September 30, 2010, the Commission voted to charge Flannery and Hopkins and to initiate an administrative proceeding claiming they were responsible, in part, for the misleading communications with Fund investors. The order instituting proceedings charged both defendants (called respondents in an administrative proceeding but called defendants here for simplicity) with primary violations of Section 17(a)(1), (2) and (3) and, without specifying subdivisions, of Rule 10b-5.²⁰

In October 2011, Chief Administrative Law Judge Brenda Murray issued an initial decision finding no violations. Hopkins did not violate Section 17(a) or Rule 10b-5, and neither did Flannery.²¹

¹⁶ *Flannery* *2.

¹⁷ Initial Decision *10-*11.

¹⁸ *Flannery* *19.

¹⁹ Id. *19-*22, *29-*32.

²⁰ *Flannery*, Admin. Proc. 3-14081 (September 30, 2010), available at <http://www.sec.gov/litigation/admin/2010/33-9147.pdf>.

²¹ See Initial Decision, note 15 supra.

The Division of Enforcement appealed to the full Commission. It argued that Flannery violated Section 17(a)(1), (2), and (3) and Rule 10b-5(a) and (c). It argued that Hopkins violated Section 17(a)(1), (2), and (3) and Rule 10b-5(a), (b), and (c).²²

A majority of the Commissioners disagreed with the ALJ. They found that Flannery violated Section 17(a)(3) of the Securities Act by engaging in a course of business that operated as a fraud on investors in the Fund, suspended him for one year from association with any investment adviser or investment company, and imposed a cease-and desist order and a \$6,500 civil money penalty. The Commissioners decided that Hopkins violated Rule 10b-5(a), (b), and (c) and Section 17(a)(1) by misrepresenting material facts concerning the Fund, suspended him for one year from association with any investment adviser or investment company, and imposed a cease-and desist order and a \$65,000 civil money penalty.²³

State Street settled SEC enforcement charges in February 2010, well before the SEC charged Flannery and Hopkins. The settlement cited violations of Section 17(a)(2)-(3) of the Securities Act.²⁴

B. **The Commission's Interpretations of Rule 10b-5 and Section 17(a).**

The opinion for the majority of Commissioners described their interpretations of Rule 10b-5(a) and (c) and the three subdivisions of Section 17(a).²⁵ This section will describe the Commission's analysis and conclusions of each subdivision and then finish by reporting how the Commission applied its reasoning to Hopkins and Flannery.

1. *Rule 10b-5.*

²² *Flannery* *19, *28.

²³ *Flannery* *42. Both defendants petitioned the First Circuit to review the SEC decision. See Petition for Review, Hopkins v. SEC, No. 15-1117 (1st Cir. Jan. 16, 2015); Petition for Review, Flannery v. SEC, No. 15-1080 (1st Cir. Jan. 14, 2015).

²⁴ In re State Street Bank and Trust Co., Admin. Proc. 3-13776 (February 4, 2010), available at <http://www.sec.gov/litigation/admin/2010/33-9107.pdf>.

²⁵ Rule 10b-5 applies to the purchase or sale of a security. Rule 10b-5(a) provides that a person may not "employ any device, scheme, or artifice to defraud." Rule 10b-5(b) provides that a person may not "make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made . . . not misleading." Rule 10b-5(c) provides that a person may not "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."

Section 17(a) applies in the offer or sale of a security. Section 17(a)(1) provides that a person may not "employ any device, scheme, or artifice to defraud." Section 17(a)(2) provides that a person may not "obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary" to make other statements not misleading. Section 17(a)(3) provides that a person may not "engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

The majority did not offer its own views of Rule 10b-5(b), which states that a person may not “make any untrue statement of a material fact,” because Rule 10b-5(b) was the subject of *Janus Capital Group v. First Derivative Traders*.²⁶ The *Flannery* opinion accepted the *Janus* construction of Rule 10b-5(b) but limited the Supreme Court decision to Rule 10b-5(b).²⁷ *Janus* held that only a person with ultimate authority for a statement makes it and that an investment adviser that wrote statements for a mutual fund prospectus was not liable under Rule 10b-5(b). The mutual fund and its directors but not the adviser had ultimate authority for the prospectus statements.²⁸

The Commission majority discussed Rule 10b-5(a) and (c). These provisions are broad anti-fraud proscriptions but reach only acts that are themselves manipulative or deceptive. The Commission concluded that a person who falsifies financial records to misstate a company’s performance or that orchestrates sham transactions designed to give the false appearance of business operations has primary Rule 10b-5(a) or (c) liability even if a material misstatement by another person creates the nexus between the scheme and the securities market.²⁹

Flannery said these subdivisions go further. They encompass a person who drafts or devises a fraudulent misstatement to investors, as well as a person who violates Rule 10b-5(b) by making such a misstatement.³⁰ The provisions also cover a person who approves or decides not to revise a misleading statement.³¹ These persons employ a deceptive device.³² *Janus* construed only the term “make” in Rule 10b-5(b).³³ It did not say a person who “makes” a false statement cannot also be liable under Rule 10b-5(a) or that a person who does not “make” a false statement cannot be liable under Rule 10b-5(a) or (c).³⁴

The *Flannery* majority said its broad constructions of Rule 10b-5(a) and (c) were consistent with the discussion of *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*³⁵ in *Janus*. The Commission reasoned that its interpretations of the prohibitions, even interpretations reaching undisclosed acts such as drafting a misstatement, were consistent with *Ston-*

²⁶ 131 S. Ct. 2296 (2011).

²⁷ *Flannery* *9.

²⁸ Id. *10.

²⁹ Id. *12.

³⁰ Id.

³¹ Id. *24.

³² Id. *13.

³³ Id.

³⁴ Id.

³⁵ 552 U.S. 148 (2008).

eridge because that case was about the reliance element in a private case. Even if conduct violated Rule 10b-5(a) or (c) under a broad reading, a private plaintiff would not necessarily be able to prove reliance on the misconduct, and therefore the Commission's positions on the substantive prohibitions of the Rule would not necessarily expand the implied private right of action.³⁶

The Commission majority did not agree with the argument that primary liability under Rule 10b-5(a) or (c) could be established only through a showing of "additional" deceptive conduct when a fraud is ultimately effected through misstatements. It acknowledged that three courts of appeals and at least one district court adopted some variation of this position³⁷ but believed the interpretation was contrary to the text of Rule 10b-5(a) and (c). Only an arbitrary reading of a deceptive device, scheme, artifice, or act would exclude the making, drafting, or devising of a misstatement.³⁸ The Commission further explained that the "beyond-a-misstatement" approach was the result of imprecise applications of *Central Bank of Denver, NA v. First Interstate Bank of Denver, NA*³⁹ over time by the lower courts and that its own interpretations of Rule 10b-5(a) and (c) were consistent with *Central Bank* and appropriately distinguished between primary and secondary liability. Primary liability applied to any person that commits a deceptive act, while a person that engages in legitimate transactions or uses accurate documents would be at most an aider and abettor.⁴⁰ The Commission majority read the subsections of Rule 10b-5 to overlap so that conduct covered by one subpart could be covered by another subpart. The subdivisions are "mutually supporting rather than mutually exclusive."⁴¹

2. Section 17(a).

³⁶ *Flannery* *13.

³⁷ *Id.* *14 & n.69 (citing *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057-58 (9th Cir. 2011); *Public Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177-78 (2d Cir. 2005); *SEC v. Kelly*, 817 F. Supp. 2d 340 (S.D.N.Y. 2010)).

³⁸ *Id.* *14.

³⁹ 511 U.S. 164 (1994).

⁴⁰ *Flannery* *15 n.73.

⁴¹ *Id.* *14 (citing *Cady, Roberts & Co.*, SEC Release No. 34-6668, 1961 WL 60638, at *4 (Nov. 8, 1961)). *Flannery* did not disclose that *Cady, Roberts* was settled before the Commission issued its opinion. *Cady, Roberts & Co.*, 1961 WL 60638, at *1. The *Cady, Roberts* opinion was not the result of adversary submissions and was not written with the discipline imposed by the threat of judicial review. *Flannery* also did not reconcile the argument that the subparts are "mutually supporting" with the Supreme Court's conclusion that each subsection of Section 17(a) "proscribes a distinct category of misconduct" and "is meant to cover additional kinds of illegalities — not to narrow the reach of the prior sections." *United States v. Naftalin* 441 U.S. 768, 774 (1979).

Flannery discussed Section 17(a)(2) in relation to Rule 10b-5(b) and *Janus*. Section 17(a)(2) has many of the same words and concepts as Rule 10b-5(b), but it does not include the phrase “make any untrue statement of a material fact,” which was the main object of the Supreme Court’s analysis in *Janus*. The *Flannery* majority said the limitation on primary liability under Rule 10b-5(b) in *Janus* therefore does not apply to Section 17(a)(2).⁴² Section 17(a)(2) prohibits obtaining money or property “by means of” a false or misleading statement and therefore covers a broader range of actions than Rule 10b-5(b) does. The phrase “by means of” refers to those who “use or employ.”⁴³ A defendant is primarily liable under Section 17(a)(2) if he uses a misstatement to obtain money or property even if he does not make the misstatement.⁴⁴ A “causal link between the misrepresentation and the acquisition of money or property” is needed; “a misrepresentation must be at least relevant to, if not the cause of, the transfer of money or property from an investor to the defendant” or his employer.⁴⁵ The Commission also discussed the need to prove that a defendant obtained money or property.⁴⁶

The Commission majority then turned to Section 17(a)(1) and (3). It first determined that, because of textual differences between Section 17(a) and section 10(b) and the Supreme Court’s recognition of those differences,⁴⁷ a defendant’s conduct does not need to be manipulative or deceptive to violate Section 17(a), although an investor must have been actually or potentially defrauded for liability to exist.⁴⁸ A footnote explained: “We can conceive of a number of ways that a defendant might contribute to a fraud through conduct that is not itself deceptive or manipulative. For example, if a defendant company executed legitimate transactions with another entity knowing that the other entity would use the transactions to misstate its revenue, the defendant company could be liable under Section 17(a) even though the transactions were not themselves deceptive.”⁴⁹

Otherwise, the Commission interpreted Section 17(a)(1) to be identical to Rule 10b-5(a), reaching “all scienter-based, misstatement-related

⁴² *Flannery* *11.

⁴³ Id.

⁴⁴ Id.

⁴⁵ Id. *25 & n.132 (citing *Loughrin v. United States*, 134 S. Ct. 2384, 2393-94 (2014)).

⁴⁶ Id. *25 nn.130-31.

⁴⁷ *Aaron v. SEC*, 446 U.S. 680 (1980).

⁴⁸ *Flannery* *16.

⁴⁹ Id. *16 n.86 (citing *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1050 (9th Cir. 2006), vacated on other grounds sub nom. *Avis Budget Group, Inc. v. Cal. State Teachers’ Ret. Sys.*, 552 U.S. 1162 (2008)).

misconduct.”⁵⁰ A person who makes a misstatement with scienter employs a device, scheme, or artifice to defraud in violation of Section 17(a)(1) as does a defendant who, with scienter, drafts or devises a misstatement or uses a misstatement made by others to defraud investors. In the conclusion of this section, the Commission majority added that Section 17(a)(1) also covers “other forms of conduct that contribute to a fraud,” a phrase apparently intended to preserve the position that a defendant’s conduct does not need to be manipulative or deceptive.⁵¹

Under Section 17(a)(3), no person may “engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” The Commission’s reading was that the provision does not require a defendant to have engaged in conduct that is deceptive and does not require proof of scienter. It applies when, “as a result of a defendant’s negligent conduct, investors receive misleading information about the nature of an investment or an issuer’s financial condition” or, “as a result of a defendant’s negligence, prospective investors are prevented from learning material information about a securities offering.” The example for this final category was a person who concealed material adverse information from sales representatives or made sure that sales representatives who learned the information withheld it from prospective investors.⁵²

The Commission decided that Section 17(a)(3) is narrower than Rule 10b-5(c) because Section 17(a)(3) uses the word “transaction” instead of the broader word “act.” A single misstatement is an act but not a transaction, and therefore the “practice” or “course of business” language in Section 17(a)(3) would not apply to a misstatement until a person repeatedly made or drafted a misstatement over a period of time.⁵³ Later the Commission narrowed the construction of practice or course of business to mean “on more than one occasion.”⁵⁴

C. **Liability of Hopkins and Flannery.**

The Commission then applied its interpretations to the conduct of Hopkins and Flannery. It found that Hopkins violated Rule 10b-5(a), Rule 10b-5(b), Rule 10b-5(c), and Section 17(a)(1). Hopkins violated Rule 10b-5(b) because he “made” the misstatements in the typical portfolio slide at a May 2007 presentation to a customer. He presented the slide, was responsible for its accuracy, and was named on the cover sheet for the presentation. He had ultimate authority over statements about the slide at

⁵⁰ Id. *17.

⁵¹ Id. *17-*18.

⁵² Id. *18 & n.101.

⁵³ Id. *18.

⁵⁴ Id. *25.

the May 2007 presentation.⁵⁵ Hopkins also violated Rule 10b-5(a), Rule 10b-5(c), and Section 17(a)(1) by that act. He employed a deceptive device and engaged in an act that operated as a fraud or deceit.⁵⁶

The Commission found that Flannery violated Section 17(a)(3). It held him responsible for material misstatements in two letters State Street sent in August 2007 to LDBF investors. Flannery contributed to and approved the letters and acted negligently in failing to correct the misleading statements in them.⁵⁷ He received a draft of the letters, edited them, and, in one letter, made changes to the language the Commission found misleading. He was a senior official and decisions not to change language were tacit approval of the contents.⁵⁸ The conduct was a “course of business” because it occurred in an important two-week period and involved more than one materially misleading communication.⁵⁹

II. **THE CONSISTENCY OF *FLANNERY*’S LEGAL CONCLUSIONS WITH SUPREME COURT AND LOWER COURT PRECEDENT.**

The main question presented in *Flannery* was the difference between primary and secondary liability under the leading anti-fraud provisions: how close must the conduct of a particular defendant be to an investor’s decision to buy or sell a security to be a primary violation? The SEC also needed to establish that a fraud, deceit, or manipulation under the securities laws occurred, usually in the form of a false or misleading statement to investors, but the big contest was whether Flannery and Hopkins had legal responsibility under a theory of primary liability. The Commissioners did not fully appreciate the proper legal analysis to apply to this question. They spent too much time parsing “device,” “scheme,” “artifice,” and “act”⁶⁰ and not enough time taking their lead from the reasoning and rationale of the leading Supreme Court precedent: *Central Bank*, *Stoneridge*, and *Janus*. Those decisions were about drawing a line between primary and secondary liability.

The consequence was that the Commission misapplied the Supreme Court decisions. That is the topic of this Part. The cases are part of the securities enforcement canon and are well known to most, but a deeper look into parts of the opinions is necessary to evaluate the SEC’s interpretations of Section 17(a) and Rule 10b-5 in *Flannery*. This is in Part II.A, which also has a short discussion of some lower court decisions that resolve issues addressed in *Flannery*.

⁵⁵ Id. *23.

⁵⁶ Id. *24.

⁵⁷ Id. *32.

⁵⁸ Id. *33.

⁵⁹ Id. *35.

⁶⁰ *Flannery* *13, *14, *24.

The review of those leading cases sets up a critique of *Flannery* in section II.B. How well do the reasoning and conclusions on Section 17(a) and Rule 10b-5 in *Flannery* fit with the court decisions? The assessment of *Flannery* reveals marked differences and raises serious questions about the reliability and sustainability of the *Flannery* opinion.

A. **Supreme Court and Lower Court Precedent on Primary Anti-Fraud Liability.**

1. *Central Bank and its Aftermath.*

The starting point is *Central Bank*.⁶¹ A public authority had sold bonds with a disclosure document allegedly containing representations that an appraisal of collateral was reliable and correct when in fact significant questions about the appraisal existed.⁶² The case therefore involved a standard type of fraudulent conduct and a primary actor, the public authority. The question for the Court was whether the indenture trustee for the bond offering was liable to private plaintiffs under a legal theory of secondary responsibility, an aiding and abetting theory. The claim was that the trustee was aware of the questions about the reliability of the appraisal and delayed an independent review of it. The Court determined that Section 10(b) liability did not extend to aiders and abettors. The scope of Section 10(b) was limited by the text, which did not mention aiding and abetting liability, and the Court did not find a reason to imply an aiding and abetting claim as part of the implied private right of action under Rule 10b-5 when none of the express causes of action in the securities acts included that liability.⁶³ The Court reached these conclusions notwithstanding a brief from the SEC and the Department of Justice arguing in favor of an aiding and abetting claim.⁶⁴

Central Bank was a private case, but the principal analysis was of the text of Section 10(b), which applied equally to SEC claims.⁶⁵ After the decision, the Commission announced it would not assert aiding and abetting theories of liability unless a statute expressly provided for it.⁶⁶

⁶¹ *Central Bank of Denver, NA v. First Interstate Bank of Denver, NA*, 511 U.S. 164 (1994).

⁶² *First Interstate Bank of Denver, NA v. Pring*, 969 F.2d 891, 893-95 (10th Cir. 1992).

⁶³ *Central Bank*, 511 U.S. at 177, 180. See *Stoneridge*, 552 U.S. at 157.

⁶⁴ *Central Bank*, 511 U.S. at 175.

⁶⁵ *Stoneridge* 552 U.S. at 167, 173 n.7 (Stevens, J., dissenting).

⁶⁶ 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, 342 n.33 (1996).

Congress responded to *Central Bank* in 1995 by adding Section 20(e) to the Exchange Act.⁶⁷ Section 20(e) allows the SEC but not a private plaintiff to bring an action against “any person that knowingly or recklessly provides substantial assistance to another person” that violated the Exchange Act or its regulations. The statute provides that the aider and abettor violates the law to the same extent as the primary violator. The result was, and the current position is, that the Section “10(b) implied private right of action does not extend to aiders and abettors. The conduct of a secondary actor must satisfy each of the elements or preconditions for” primary liability.⁶⁸

Central Bank and Section 20(e) effected a massive change in the securities litigation and enforcement landscape. They made the line between primary and secondary securities misconduct relevant. The difference between primary and secondary liability became critical in private cases because a private plaintiff could not sue an aider and abettor.⁶⁹ The distinction also has been meaningful for SEC enforcement cases because the Commission prefers primary fraud charges to secondary liability theories.⁷⁰ Section 20(e) draws the line. An aider and abettor is a person that

⁶⁷ Pub. L. No. 104-67, § 104, 109 Stat. 737, 757 (1995) (codified at 15 U.S.C. § 78t(e)).

⁶⁸ *Stoneridge*, 552 U.S. at 158.

⁶⁹ See *Janus*, 131 S. Ct. at 2302 n.6 (“for *Central Bank* to have any meaning, there must be some distinction between those who are primarily liable (and thus may be pursued in private suits) and those who are secondarily liable (and thus may not be pursued in private suits”); the majority’s goal was to “draw a clean line between the two”).)

⁷⁰ The *Flannery* opinion itself is compelling support for the proposition that the SEC favors primary fraud charges. The agency does not need broad primary liability for its enforcement program. It may assert claims for aiding and abetting under Section 20(e) and control person liability under Section 20(a) and, under Section 21C(a), 15 U.S.C. § 78u-3(a), may seek relief in an administrative proceeding against a person causing another person’s violation. The Commission headed off the criticism that its broad readings of Rule 10b-5 were to help private plaintiffs because it asserted that private plaintiffs would still need to satisfy the reliance requirement as narrowed in *Stoneridge*. *Flannery* *13. The charging decisions in *Flannery* are further evidence that the SEC prefers primary fraud charges, as are the Commission’s vigorous efforts to assert “scheme” liability, see, e.g., *SEC v. Goldstone*, 952 F. Supp. 2d 1060, 1133 (D.N.M. 2013); *SEC v. Kelly*, 817 F. Supp. 2d 340, 342 (S.D.N.Y. 2010). Additional evidence is the Commission’s exploration of the use of Section 20(b) of the Exchange Act, 15 U.S.C. § 78t(b), to respond to the Supreme Court’s decision in *Janus*. Marc J. Fagel & Monica K. Loseman, Exchange Act Section 20(b): The SEC Enforcement Division Dusts Off an Old Weapon, 18 Wall Street Lawyer 1, 1 (2014), [http://www.gibsondunn.com/publications/Documents/Fagel-Loseman-SEC-Exchange-Act-Section-20\(b\)-Wall-Street-Lawyer-September-2014.pdf](http://www.gibsondunn.com/publications/Documents/Fagel-Loseman-SEC-Exchange-Act-Section-20(b)-Wall-Street-Lawyer-September-2014.pdf); Mary Jo White, Chair, Securities and Exchange Commission, Three Key Pressure Points in the Current Enforcement Environment (May 19, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541858285#.VQoPtCmenjI>; Yin Wilczek, SEC to Aggressively Use Obscure Provision To Pursue Individuals, Chairman Says, Bloomberg BNA Securities Law Daily (May 23, 2014).

substantially assists a primary violation. The conduct of a primary violator must be more than substantial assistance.⁷¹

Private plaintiffs responded to *Central Bank* by seeking to expand the scope of primary liability under Rule 10b-5 to reach solvent and deep-pocket defendants. For example, the shareholders of Enron sued several broker-dealers for their role in transactions allowing Enron to misstate its financial condition with improper accounting.⁷²

The shareholders of Homestore sued independent parties that had contracts with the company and alleged that the parties entered into fraudulent transactions that allowed Homestore to record revenue in violation of SEC accounting rules. The SEC filed an amicus brief in the case urging the court of appeals to reach the independent parties with this standard: A person is a primary violator when it directly or indirectly engages in a transaction whose principal purpose and effect is to create a false appearance of fact.⁷³ The SEC argued that the reliance requirement in a private case would be “satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction.”⁷⁴

Another case involved allegations against suppliers of a cable company called Charter Communications.⁷⁵ The plaintiff alleged that the issuer falsely and materially inflated its revenues and earnings by entering into certain commercial arrangements with the suppliers to allow the issuer to record extra revenue and to postpone recording certain expenses. The allegation was that the issuer and the suppliers drafted contracts and documents in a way to conceal the true nature of the arrangements, which included an overpayment by the issuer to the suppliers and then purchases of advertising from the issuer by the suppliers. One supplier sent the issuer a document falsely stating that increased production costs were the

⁷¹ *Central Bank*, 511 U.S. at 167, 176 (primary violators are those who engage in the manipulative or deceptive practice; “aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do.”).

⁷² *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007).

⁷³ *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), vacated sub nom. *Avis Budget Group, Inc. v. Cal. State Teachers' Ret. Sys.*, 552 U.S. 1162 (2008) (certiorari granted, and decision vacated and remanded in light of *Stoneridge*).

⁷⁴ In his *Stoneridge* dissent, Justice Stevens quoted the SEC amicus brief. *Stoneridge* 552 U.S. at 167, 168 n.2 (Stevens, J., dissenting). The amicus brief is available at https://www.sec.gov/litigation/briefs/homestore_102104.pdf.

⁷⁵ *In re Charter Communications, Inc., Sec. Litig.*, 443 F.3d 987 (8th Cir. 2006). The facts in the text are from the decisions of the Supreme Court and the court of appeals.

cause of the price increases for the supplies. The contract with the other supplier specified a quantity that neither party expected the issuer to need and added a liquidated damages provision as a method of having the issuer make overpayments to the supplier. Another allegation was that both supply contracts were backdated. The suppliers played no role in the preparation of the issuer's publicly disclosed financial statements.

The plaintiffs in *Charter* argued that they had properly alleged a primary violation of the securities laws within the meaning of *Central Bank* because the suppliers violated Rule 10b-5(a) and (c) by participating in a "scheme or artifice to defraud" and by engaging in a "course of business which operates . . . as a fraud or deceit." The Eighth Circuit held that *Central Bank* barred the plaintiffs' claim against the suppliers: "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5."⁷⁶

The issue in each of these court of appeals cases was not whether a traditional kind of securities deception had occurred or whether a person with primary liability existed. In each, the allegation was that a publicly reporting company had made a false statement of material fact to the market. The material false statement was the alleged securities fraud, and the issuer was the person with primary liability. Instead, the question was whether a defendant other than the publicly reporting company was a proper defendant for purposes of primary liability.

2. *Stoneridge*.

The activity in the courts of appeals led the Supreme Court to grant review in the *Charter Communications* case, which became *Stoneridge*.⁷⁷ While the case was pending, expectations were high that the Court would begin to draw the line between primary and secondary misconduct. The question presented in *Stoneridge*'s petition for a writ of certiorari asked if *Central Bank* foreclosed a claim under Rule 10b-5(a) or (c) when the defendant did not make a public statement. The question presented did not raise the reliance issue and did not mention the word reliance.⁷⁸ The Supreme Court granted the petition without modifying the question.⁷⁹

⁷⁶ In re *Charter Communications, Inc.*, Sec. Litig., 443 F.3d 987, 991-92 (8th Cir. 2006).

⁷⁷ *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

⁷⁸ Petition for a Writ of Certiorari, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (No. 06-43), 2006 WL 1909677.

⁷⁹ *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 549 U.S. 1304 (2007).

In the Supreme Court, the plaintiffs argued for a broad test of primary liability that would have captured the suppliers. The plaintiffs claimed that the suppliers “engaged in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent Charter’s revenue. The ... financial statement Charter released to the public was a natural and expected consequence of [the suppliers’] deceptive acts.”⁸⁰ The plaintiffs’ position used nearly the same formulation of words that the SEC’s amicus brief and the Ninth Circuit’s opinion in *AOL* had.

The Court did not adopt the plaintiffs’ test. It held that the suppliers were not liable to the plaintiffs but disposed of the case on the reliance element, applying a proximate causation test. The majority invoked concepts of remoteness, lack of control, attenuation, indirect chains, and intervening independent acts in its causation discussion.⁸¹ For example, the Court said that the connection between the acts of the suppliers and Charter’s false financial statements was an “indirect chain that we find too remote for liability.”⁸² It drew a sharp distinction between the person that made the public misstatements, the publicly reporting company, and others that played some role in them: The suppliers’ “deceptive acts, which were not disclosed to the investing public, are too remote to satisfy the requirement of reliance. It was Charter, not [the suppliers], that misled its auditor and filed fraudulent financial statements; nothing [the suppliers] did made it necessary or inevitable for Charter to record the transactions as it did.”⁸³ An actor “free to do as it chose” in issuing financial statements and public disclosures breaks a causal chain, at least for purposes of the reliance requirement.⁸⁴ Holding the suppliers liable as primary actors would go too far. Primary liability under Rule 10b-5 “does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way.”⁸⁵

The main issue discussed in the *Stoneridge* opinions was the ambit of the reliance, or transaction causation, element of an implied private right of action under Rule 10b-5, but the reasoning and analysis were not so limited. Part of the Court’s reasoning was that the plaintiffs’ rule of liability would contravene *Central Bank* and Section 20(e) by converting aiders and abettors into primary violators:

Petitioner’s theory, moreover, would put an unsupportable interpretation on Congress’ specific response to *Central Bank* in § 104 of

⁸⁰ *Stoneridge*, 552 U.S. at 160.

⁸¹ *Id.* at 160-62, 166.

⁸² *Id.* at 159.

⁸³ *Id.* at 161.

⁸⁴ *Id.* at 166-67.

⁸⁵ *Id.* at 162.

the PSLRA. Congress amended the securities laws to provide for limited coverage of aiders and abettors. Aiding and abetting liability is authorized in actions brought by the SEC but not by private parties. See 15 U.S.C. § 78t(e). Petitioner's view of primary liability makes any aider and abettor liable under § 10(b) if he or she committed a deceptive act in the process of providing assistance. ... Were we to adopt this construction of § 10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants.⁸⁶

The majority opinion thus unequivocally put the suppliers in the category of potential secondary liability rather than primary liability, as did the SEC in enforcement cases against the suppliers.⁸⁷

In addition, the Court said that the breadth of the plaintiffs' theory affected the requirement that a deceptive act be "in connection with the purchase or sale of a security." That element applies to all claims under Rule 10b-5 including SEC enforcement cases. The majority opinion imposed limits on the use of "but for" causality for the "in connection with" requirement. Although the Court said it was not evaluating the "in connection with" requirement, the majority opinion included -- with no apparent need -- several passages indicating that it perceived a relationship between the "in connection with" element and the Court's causation analysis for purposes of the reliance requirement. It said that "the emphasis on a purchase or sale of securities does provide some insight into the deceptive acts that concerned the enacting Congress" and then, as support, quoted a law review article stating that the "in connection with" and reliance-causation requirements "are related to each other" and "may merge" with each other.⁸⁸ Rule 10b-5 applied to the securities markets, the "in-

⁸⁶ Id. at 162-63.

⁸⁷ The SEC settled enforcement cases with both suppliers for substantially similar conduct with Adelphia Communications, but, when the SEC sued, it used theories of secondary liability (either aiding and abetting or causing) and not a claim of primary liability. See SEC Charges Scientific-Atlanta for Aiding and Abetting and Two Senior Executives for Causing Adelphia's Reporting Violations, SEC Litig. Rel. No. 19735 (June 22, 2006), available at <http://www.sec.gov/litigation/litreleases/2006/lr19735.htm>; In re Motorola, Inc., Exchange Act Rel. No. 55725 (settled order instituting proceedings May 8, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55725.pdf>.

⁸⁸ The majority used the law review article and quotation to tie the reliance-transaction causation analysis to the "in connection with" requirement, but the cited portion of the article discusses the relationship between the "in connection with" requirement and loss causation, not reliance. Barbara Black, *The Second Circuit's Approach to the "In Connection With" Requirement of Rule 10b-5*, 53 Brooklyn L. Rev. 539, 541 (1987) (when the Second Circuit determined that a fraud did not cause the injury complained of,

vestment sphere,” and not the realm of ordinary business operations.⁸⁹ In this way, the Court indicated that its causation analysis could apply to other elements of a securities anti-fraud claim.

The majority opinion listed several other reasons for refusing to extend the Rule 10b-5 claim to the conduct of the suppliers. They included federalism and separation of powers concerns.⁹⁰ They also included a concern about expanding a judicially created private cause of action.⁹¹

The majority opinion in *Stoneridge* communicated that its line-drawing and analysis extended beyond the reliance element alone. *Flannery* read the discussions of reliance in *Janus* and *Stoneridge* to confine the effect of those decisions to private claims and not to preclude Commission enforcement actions,⁹² but was the Court’s opinion reasonably susceptible to the conclusion that the suppliers would have been primarily liable under Rule 10b-5 in an SEC case? Was the analysis in *Stoneridge* really suggesting that the supplier defendants had committed a primary violation of Rule 10b-5 but that a private plaintiff could not maintain the claim because the reliance element for the implied private action was missing? A full and fair reading of the reasoning in *Stoneridge* makes that a difficult conclusion to sustain.

3. *Janus*.

Janus is the next in this line of Supreme Court decisions.⁹³ As in *Central Bank* and *Stoneridge*, the existence of a securities fraud and a defendant with primary liability were separate from the question before the Court. The alleged fraud in *Janus* was the false statements about market timing in the prospectuses for securities of several mutual funds. The mutual funds issued the prospectuses and had primary liability. The question for the Court was whether a different entity in the *Janus* corporate group, the investment adviser to the funds, had primary liability to the plaintiffs under Rule 10b-5 because of the role the adviser played in preparing the prospectuses.

The Court concentrated its analysis on whether the investment adviser "made" the allegedly false statements for purposes of Rule 10b-5. It

and therefore was not in connection with the securities transaction, it analyzed the in connection with requirement in terms of loss causation).

⁸⁹ *Stoneridge*, 552 U.S. at 160, 161, 162, 166.

⁹⁰ *Id.* at 161-66.

⁹¹ *Id.* at 165-66.

⁹² *Flannery* *13.

⁹³ *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

cited and quoted the prohibition in Rule 10b-5(b), which says that a person may not “make any untrue statement of a material fact.”⁹⁴

The Court referred to several dictionary definitions of the phrase “to make a statement” and then concluded:

For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not “make” a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed.⁹⁵

The conclusion followed from *Central Bank* and *Stoneridge* more than it was compelled by the language in Rule 10b-5. The word “make” did not lead inevitably to the person with ultimate authority and control, as Justice Breyer’s dissent pointed out.⁹⁶ *Janus* expressed significant concern with wider constructions of the maker of a statement because of the need to maintain the difference between primary and secondary liability. “A broader reading of ‘make,’ including persons or entities without ultimate control over the content of a statement, would substantially undermine *Central Bank*. If persons or entities without control over the content of a statement could be considered primary violators who ‘made’ the statement, then aiders and abettors would be almost nonexistent.”⁹⁷ The Court briefly noted that its holding was consistent with “the narrow scope that we must give the implied private right of action.”⁹⁸

The Court invoked *Stoneridge* to reject broader tests for primary liability from both the government and the plaintiffs. The brief from the Department of Justice and the SEC urged this standard: “a person makes a false or misleading statement and thus can be liable as a primary violator of Rule 10b-5 when that person creates the statement, which occurs when the statement is written or spoken by him, or if he provides the false or misleading information that another person then puts into the statement,

⁹⁴ *Janus*, 131 S. Ct. at 2301.

⁹⁵ *Id.* at 2302.

⁹⁶ *Stoneridge*, 131 S. Ct. at 2305, 2306 (Breyer, J., dissenting) (“Neither common English nor this Court’s earlier cases limit the scope of that word to those with ‘ultimate authority’ over a statement’s content.”).

⁹⁷ *Id.* at 2303.

⁹⁸ *Id.* at 2303.

or if he allows the statement to be attributed to him.”⁹⁹ The plaintiffs argued that an investment adviser should generally be understood to be the “maker” of statements by its client mutual fund because of the uniquely close relationship between an adviser and a fund and the significant influence of the adviser.¹⁰⁰

The Court cited *Stoneridge* as precedent against the standards offered by the government and the plaintiffs: “

Adopting the Government's definition of ‘make’ would also lead to results inconsistent with our precedent. The Government's definition would permit private plaintiffs to sue a person who ‘provides the false or misleading information that another person then puts into the statement.’ ... But in *Stoneridge*, we rejected a private Rule 10b-5 suit against companies involved in deceptive transactions, even when information about those transactions was later incorporated into false public statements. ... We see no reason to treat participating in the drafting of a false statement differently from engaging in deceptive transactions, when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement.¹⁰¹

The majority saw the funds and the adviser as separate legal entities that had observed the necessary corporate formalities.¹⁰² As in *Stoneridge*, it was not “necessary or inevitable” that a falsehood from one person would be contained in the other person’s statement.¹⁰³

In this part of the opinion, the Court deflected the SEC and Department of Justice’s assertion that the Court should defer to the SEC’s interpretation of “make.”¹⁰⁴ Signaling frustration with the persistently expansive legal positions of the SEC, the majority also rebuked the government: “This also is not the first time this Court has disagreed with the SEC's broad view of § 10(b) or Rule 10b-5,”¹⁰⁵ citing four cases as examples.¹⁰⁶

⁹⁹ Brief for the United States as Amicus Curiae Supporting Respondent, *Janus*, 131 S. Ct. 2296 (2011) (No. 09-525), 2010 WL 4339892, *13 (quotation marks and citation omitted).

¹⁰⁰ *Janus*, 131 S. Ct. at 2304.

¹⁰¹ *Id.* at 2303-04 (citations and footnote omitted).

¹⁰² *Id.* at 2304, 2305.

¹⁰³ *Id.* at 2303.

¹⁰⁴ *Id.* at 2303 n.8.

¹⁰⁵ *Id.*

¹⁰⁶ The four cases were *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A.*, 511 U.S. 164, 188-191 (1994); *Dirks v. SEC*, 463 U.S. 646, 666, n. 27 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 207 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 746, n. 10 (1975). The list of cases in which the Supreme Court re-

The Court's application of *Stoneridge* to dispose of the tests for primary liability proposed by the government and the plaintiffs is significant for two reasons. First, it was evidence that the Court did not see *Stoneridge* as limited to the reliance element. *Janus* did not apply the reliance element and instead analyzed the coverage of the explicit prohibitions in Rule 10b-5, but the rationale of the decision advanced themes from and was consistent with *Stoneridge*. *Janus* featured the same proximate cause terminology found in *Stoneridge*: ultimate authority and control and independent choices of separate legal entities. Both decisions appear to be better read as expressions of the Supreme Court's view that primary liability under Rule 10b-5 is confined and does not extend to all persons with some connection to false information received by an investor.

Second, the *Janus* Court's use of *Stoneridge* demonstrates that the Court's reasoning in *Janus* was not limited to an interpretation of subpart (b) of Rule 10b-5. The analysis and reasoning in *Stoneridge* applied to all of Rule 10b-5, not just Rule 10b-5(b).

Other evidence indicates that the *Janus* majority did not limit its assessment of the adviser's potential liability under Rule 10b-5 to sub-part (b) and seemed to equate liability for making a false statement to liability under Rule 10b-5 generally. The opening paragraph of the opinion referred to Rule 10b-5 and not to any particular sub-part,¹⁰⁷ and the opinion as a whole mentioned or cited Rule 10b-5 24 times and Rule 10b-5(b) only twice. The dissent mentioned or cited Rule 10b-5 14 times and Rule 10b-5(b) once.

When the Court granted certiorari in *Janus*, the questions presented were not limited to subpart (b) of Rule 10b-5. They were about primary liability in a private securities case under Rule 10b-5. The petitioners asked whether the court of appeals had erred in concluding that a service provider could be held primarily liable in a private securities-fraud action for "help[ing]" or "participating in" another company's misstatements not

jected the position of the SEC and adopted a substantially different rule of law on the meaning of Rule 10b-5 now has *Janus* itself and *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014) (rejecting proposed interpretation of "in connection with" in Securities Litigation Uniform Standards Act, which has same definition for Rule 10b-5), and, at the time of *Janus*, included additional cases: *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2882 (2010) (rejecting government arguments for extraterritorial application of Rule 10b-5 and other federal securities laws); *Aaron v. SEC*, 446 U.S. 680 (1980) (rejecting government argument that the SEC did not need to prove scienter in a Rule 10b-5 claim).

¹⁰⁷ *Janus*, 131 S. Ct. at 2299, 2301.

attributed to the service provider.¹⁰⁸ The Supreme Court granted the petition without modifying the question.¹⁰⁹

4. *Application of Janus and Stoneridge in the Lower Federal Courts.*

Since *Stoneridge* and *Janus*, the lower federal courts have faced a variety of situations requiring application of the decisions but have not reached uniform and consistent conclusions. Several courts of appeals issued decisions that are contrary to the outcome in *Flannery* and that *Flannery* sought to distinguish. More recently, some appellate panels have taken positions in line with *Flannery*. Indeed, *Flannery* is already affecting judicial decisions, as was intended; a 2015 Eleventh Circuit decision cited *Flannery* to support the view that *Janus* does not apply to Section 17(a). The paragraphs below look at some of the themes emerging from the courts of appeals and district courts but are not intended to be a comprehensive survey.

(a) Precedent inconsistent with *Flannery*.

A substantial body of judicial authority disagrees with outcomes in *Flannery*. An example is *Fezzani v. Bear Stearns & Co.*¹¹⁰ The main defendant was a broker-dealer, whose sales force falsely represented that the stocks of new companies were the subject of an active, rising market. Investors were led to believe that the prices they paid were set by trading in a legitimate market. In fact, the market was a series of artificial trades orchestrated by the broker-dealer to create a false appearance of volume and increasing price. Certain third parties trusted by the broker-dealer furthered the plan by buying the stock subject to the broker-dealer's promise to buy back shares at a higher price.¹¹¹ The court's decision concerned the Rule 10b-5 claim against one of the collaborating investors. The court discussed *Stoneridge*, recognized that it addressed the reliance element, but broadened the *Stoneridge* principle: "an allegation of acts facilitating or even indispensable to a fraud is not sufficient to state a claim if those acts were not the particular misrepresentations that deceived the investor."¹¹² The court said *Janus* elaborated the test from *Stoneridge*. It did not cite Rule 10b-5(b), say *Janus* was limited to Rule 10b-5(b), or limit *Stoneridge* to reliance. Under *Stoneridge* and *Janus*, "only the person who communicates the misrepresentation is liable in private actions under Section

¹⁰⁸ See Petition for a Writ of Certiorari, *Janus*, 131 S. Ct. 2296 (2011) (No. 09-525), 2009 WL 3614467; Brief for Petitioners, *Janus*, 131 S. Ct. 2296 (2011) (No. 09-525), 2010 WL 3501188.

¹⁰⁹ *Janus*, 130 S. Ct. 3499 (2010) (order granting the petition for a writ of certiorari).

¹¹⁰ 716 F.3d 18 (2d Cir. 2013).

¹¹¹ *Id.* at 21.

¹¹² *Id.* at 24.

10(b).”¹¹³ In this case, only the broker-dealer communicated the artificial price information to the victims, and the allegations against the collaborating investor therefore failed to state a claim.¹¹⁴

Another example is *SEC v. Kelly*,¹¹⁵ a district court opinion issued shortly after *Janus*. *Flannery* explicitly disagreed with this decision, but the judge’s side of things is useful. The defendants were executives at AOL who structured transactions with contracting parties. In the transactions, AOL bought goods from the counterparties and sold them on-line advertising. The SEC alleged that AOL improperly recognized revenue from the transactions and that the defendants had primary liability for AOL’s false financial reporting under Rule 10b-5(a) and (c) and Section 17(a) because they engineered, oversaw, and executed a scheme to inflate AOL’s revenue. The court accepted that *Janus* dealt with subsection (b) and not (a) or (c) of Rule 10b-5 but recognized that the Supreme Court sought to preserve the distinction between primary and secondary liability. The court held that the SEC could not assert claims under part (a) or (c) of Rule 10b-5 as a “back door” theory of liability for alleged public misrepresentations, which were at stake in the case, because allowing the SEC to use subparts (a) and (c) in that way “would render the rule announced in *Janus* meaningless.”¹¹⁶ The court also dismissed claims under Section 17(a), reasoning that the elements of a claim under Section 17(a) are essentially the same as under Rule 10b-5 and that, notwithstanding the different words, Section 17(a)(2) and Rule 10b-5(b) “have the same functional meaning when it comes to creating primary liability.”¹¹⁷

Several courts of appeals also held that a claim for scheme liability under Rule 10b-5(a) or (c) could not be used to circumvent subpart (b) when the fraud was a false public disclosure. In one case, the plaintiff pleaded a Rule 10b-5(a) and (c) scheme liability claim as well as a Rule 10b-5(b) omission claim. It alleged that the defendants carried out a plan, scheme, and course of conduct that was intended to and did deceive the plaintiff into continuing to invest in and support the company by concealing certain information from the plaintiff. The court dismissed the claim, holding that a “defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b-5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions.” The court “emphasized the importance of

¹¹³ Id. at 25.

¹¹⁴ Id.

¹¹⁵ 817 F. Supp. 2d 340 (S.D.N.Y. 2011).

¹¹⁶ Id. at 343-44.

¹¹⁷ Id. at 345. Similarly, the ALJ in *Flannery* concluded that *Janus* applied to all of Rule 10b-5 and to Section 17(a). Initial Decision *35.

maintaining a distinction among the various Rule 10b-5 claims from one another.”¹¹⁸

A district court reviewed these scheme liability decisions, agreed with them, and explained them as necessary to preserve a line between primary violators and aiders and abettors. The district court said: “To hold otherwise would allow plaintiffs, such as the SEC, to overcome the Supreme Court’s sharp distinction between those who are primarily liable for engaging in deceptive conduct, and those who only aid and abet the primary violation of another.”¹¹⁹ It applied its conclusions to claims under Section 17(a) and Rule 10b-5.¹²⁰

(b) Precedent consistent with *Flannery*.

Some recent appellate rulings reached conclusions consistent with those in *Flannery*. In a case before the Eleventh Circuit, a company called CyberKey had made materially false statements to the public about securing contracts to supply a large customer. The defendants in the case were firms and employees of those firms that provided services, such as investor and public relations services, to CyberKey and other micro-cap companies. The firms drafted press releases for the company based on information from the company and distributed the false news from the company. The firms received company stock as compensation and sold the stock in the market. The SEC alleged that the defendants committed violations of Section 17(a), but the defendants argued that *Janus* applied to Section 17(a) and that they were not the makers of the statements. The court disagreed. *Janus* was limited to Rule 10b-5(b) and the phrase “make any untrue statement of material fact.” Section 17(a) does not use the word “make.” The court agreed with the First Circuit in *SEC v. Tambone*¹²¹ that Section

¹¹⁸ WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1057 (9th Cir. 2011). See also Pub. Pension Fund Grp. v. KV Pharma. Co., 679 F.3d 972, 987 (8th Cir. 2012) (a scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b-5(b).); Lentell v. Merrill Lynch & Co., 396 F.3d 161, 177 (2d Cir. 2005) (“[W]here the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a market manipulation claim under Rule 10b-5(a) and (c).”); In re DVI, Inc. Sec. Litig., 639 F.3d 623, 642-49 (3d Cir. 2011) (court applied *Stoneridge* to deny class certification for scheme liability claims under Rule 10b-5(a) and (c) against an outside lawyer alleged to have participated in preparing a company’s misleading public disclosures); Pacific Investment Management Co. v. Mayer Brown LLP, 603 F.3d 144 (2d Cir. 2010) (court rejected scheme liability claims under Rule 10b-5(a) and (c) against an outside lawyer who participated in preparing a company’s misleading public disclosures).

¹¹⁹ SEC v. Goldstone, 952 F. Supp. 2d 1060, 1235 (D.N.M. 2013).

¹²⁰ Id. at 1234-36.

¹²¹ SEC v. Tambone, 597 F.3d 436, 444 (1st Cir. 2010) (en banc) (court compared the language of Section 17(a)(2) and Rule 10b-5(b) and concluded that “Section 17(a)(2) may fairly be read to cover the ‘use’ of an untrue statement to obtain money or property” but Rule 10b-5(b) does not extend that far).

17(a)(2) applies to a person's use of a false statement and encompasses a broader range of conduct than Rule 10b-5(b).¹²² The Eleventh Circuit decided that *Janus*'s limitation on primary liability under Rule 10b-5(b) did not apply to claims arising under Section 17(a)(2) and cited *Flannery* as support.¹²³

Another case that supports *Flannery* is *SEC v. Pentagon Capital Management PLC*.¹²⁴ Chester formed Pentagon, which engaged in late trading. It traded through broker-dealers, and the broker-dealers communicated trades with false trade times directly to mutual funds. Chester and Pentagon therefore argued they could not be liable under *Janus* because they did not communicate directly with the mutual funds. The court was not persuaded. "To the extent that late trading requires a 'statement' in the form of a transmission to a clearing broker, we find that in this case, Pentagon and Chester were as much 'makers' of those statements as were the brokers The brokers may have been responsible for the act of communication, but Pentagon and Chester retained ultimate control over both the content of the communication and the decision to late trade."¹²⁵ The court's position was that the late trading by Chester and Pentagon "violated all three subsections of Rule 10b-5, not just subsection (b), which was the only subsection at issue in *Janus*" and Section 17(a).¹²⁶

B. **Comparison of *Flannery* and Judicial Precedent.**

Now we must compare the principles from the Supreme Court and court of appeals precedent with the legal conclusions in *Flannery*. How well do they match up? We will begin with the SEC's willingness to adopt flexible interpretations of the law and then examine the SEC's positions on Rule 10b-5(a) and (c) and each part of Section 17(a).

1. *The SEC's interpretive policy.*

¹²² *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786 (11th Cir. 2015). District courts have reached similar conclusions. See, e.g., *SEC v. Stoker*, 865 F. Supp. 2d 457, 465-66 (S.D.N.Y. 2012) (court discussed *Janus*, concluded that Section 17(a)(2) should be read more broadly than Rule 10b-5(b), and cited other district court cases not applying *Janus* to Section 17(a)).

¹²³ *Big Apple Consulting USA, Inc.*, 783 F.3d at 797 (citing *Flannery* at *11). An earlier Eleventh Circuit decision examined whether officers of a publicly reporting company could have primary liability under Section 17(a) and Rule 10b-5(a) and (c) for the company's false financial reports. The court said they could: "*Janus* only discussed what it means to 'make' a statement for purposes of Rule 10b-5(b), and did not concern Section 17(a)(1) or (3) or Rule 10b-5(a) or (c)." *SEC v. Monterosso*, 756 F.3d 1326, 1334 (11th Cir. 2014).

¹²⁴ 725 F.3d 279 (2d Cir. 2013).

¹²⁵ *Id.* at 286-87.

¹²⁶ *Id.* at 287.

A key difference between the SEC's and the Supreme Court's analysis of the scope of liability under the anti-fraud provisions was the SEC's reliance on a loose and unprincipled interpretive policy. For the Commission, far-reaching interpretations were justified because of the "remedial purposes" of the securities laws. The Supreme Court long ago shunned the use of that policy and did not invoke it in *Central Bank*, *Stoneridge*, *Janus*, or other recent decisions.

Early in the legal discussion, the SEC cited "the remedial purposes of the Securities Act, as well as our long-held position that the securities laws should not be construed technically and restrictively, but flexibly to effectuate [those] remedial purposes."¹²⁷ It then referred to this policy five more times in the legal analysis section of the opinion.¹²⁸ The Commissioners were candid that they were resorting to "policy objectives"; "technical or restrictive views" "would unnecessarily limit our enforcement authority" and the agency's "flexibility in charging."¹²⁹

This interpretive policy has a checkered and questionable history. To be sure, several Supreme Court decisions invoked the same interpretive approach,¹³⁰ but the description in *Flannery* is no longer complete. As far back as *Ernst & Ernst v. Hochfelder*, the Court rejected a Commission legal interpretation because the standard of liability created by a particular section of the Securities Act or Exchange Act must "rest primarily on the language of that section."¹³¹ Statutory constructions based on the remedial purposes of the acts are no longer persuasive: "generalized references to the remedial purposes" of the securities laws "will not justify reading a provision more broadly than its language and the statutory scheme reasonably permit."¹³²

The current interpretive approach of the Supreme Court does not give noticeable weight to the remedial purposes of the securities laws and a desire to construe them flexibly.¹³³ If the policy were an important interpretive tool, it would have applied to Rule 10b-5 in *Janus*, yet the Court

¹²⁷ *Flannery* *11 (internal quotation marks and citations omitted).

¹²⁸ *Id.* at *12, *14, *16, *18, *19.

¹²⁹ *Flannery* *11, *16, *19.

¹³⁰ See *Flannery* *11 n.42 (citing Supreme Court decisions, the latest of which was 1972).

¹³¹ 425 U.S. 185, 200-01 (1976).

¹³² *Aaron v. SEC*, 446 U.S. 680, 695 (1980) (quoting and citing *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979); *SEC v. Sloan*, 436 U.S. 103, 116 (1978); internal quotation marks omitted).

¹³³ For example, the Court did not apply the interpretive policy to define the statute of limitations in section 16(b) of the Exchange Act, *Credit Suisse Sec. (USA) LLC v. Simmonds*, 132 S. Ct. 1414 (2012), or the "in connection with" phrase in the Securities Litigation Uniform Standards Act, *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1069 (2014) (rejecting arguments to use the interpretive policy for a broad meaning).

did not cite the remedial purposes policy in *Janus* and did not apply it. To the contrary, the *Janus* Court said it must give “narrow dimensions” to the meaning of Rule 10b-5 in a private case.¹³⁴ Similarly, the Court could have used a flexible approach in the discussion of reliance and Rule 10b-5 in *Stoneridge*, but it did not. Instead, it gave a list of reasons for not inflating the coverage of the Rule, apparently responding to the dissent’s call for empowering judges with the discretion to fashion a remedy for every wrong.¹³⁵

Recourse to an interpretive policy grounded on remedial purposes and flexibility has serious flaws other than its detachment from statutory text, structure, and context. It is empty of real content with little in the way of boundaries. It is not grounded on legal rigor or disciplined legal analysis and instead caters to subjectivity and personal discretion. Without the inhibitions of technical or restrictive views, a decision-maker may extend and expand the reach of a liability provision to a new situation the judge or regulator believes should be regulated. In contested litigation, flexibility and remedial purposes typically translate into application of the anti-fraud and disclosure regimes in the federal securities laws. As in *Flannery*, the interpretive policy, as a matter of practice, is a one-way ratchet to expand a liability provision. A construction to achieve remedial purposes gives no weight to countervailing policies that Congress took or would have taken into consideration if faced with concrete questions about how far to extend a liability provision. Potential liability imposes compliance costs and reduces truthful and socially beneficial disclosures.¹³⁶

Brennan v. Midwestern Life Ins. Co. shows the perils of interpreting Rule 10b-5 flexibly to implement its purposes. The district court allowed a private aiding and abetting claim under Rule 10b-5 because, “[i]n the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes.”¹³⁷ The Seventh Circuit affirmed, and the Supreme Court denied certiorari.¹³⁸ Years later, in *Central Bank*, when actually faced with the question whether the Exchange Act at that time permitted an aiding and abetting claim, the Supreme Court held that it did not.

¹³⁴ *Janus*, 131 S. Ct. at 2302 (quoting *Stoneridge*, 552 U.S. at 167).

¹³⁵ *Stoneridge*, 552 U.S. at 167, 176-80 (Stevens, J., dissenting).

¹³⁶ Richard A. Posner, *Economic Analysis of Law* 616 (9th ed. 2014) (imposing fraud liability on a corporation creates an incentive for the corporation to police its managers more carefully); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 Va. L. Rev. 623, 646-56 (1992) (expanding securities fraud liability reduces beneficial disclosures).

¹³⁷ 259 F. Supp. 673, 680-81 (N.D. Ind. 1966).

¹³⁸ 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989 (1970).

Flannery's frequent reliance on flexible interpretations to achieve the remedial purposes of the securities laws was outmoded and raises worries about inclusive but unsound conclusions of law. Loud alarm bells should go off any time a court or agency defends a legal interpretation on the broad remedial purposes of a statute.

2. *Rule 10b-5.*

Now we should begin to measure the results in *Flannery* against the legal precedents. The Commission's interpretation of Rule 10b-5(a) and (c) is the place to start, and that interpretation is squarely at odds with the Supreme Court's approach and reasoning in *Central Bank*, *Stoneridge*, and *Janus*.

The Court sent strong signals in *Stoneridge* and *Janus* that its reasoning and analysis were not limited to the reliance element in private cases or to subpart (b) of Rule 10b-5. Perhaps the Court meant to go no further -- future decisions will tell -- but, for the reasons discussed above,¹³⁹ the better reading at the moment is that the Court was developing principles for separating persons with primary responsibility from those liable as aiders and abettors. Nonetheless, *Flannery* stood on the limitations. The Commission read the parts of the Supreme Court decisions that were not consistent with broad and expansive coverage of the anti-fraud provisions in a formalistic, narrow, and technical way and read precedents consistent with its objectives in a wide, generous way. The flaw in *Flannery* was not a misunderstanding of the Supreme Court opinions, and *Flannery* was not so clumsy as to contradict or disagree in overt terms with the specific legal holdings of Supreme Court precedent. The SEC was careful to nod to the specific legal holdings. No, the flaw in *Flannery* was that the SEC failed to heed the reasoning, concerns, and legal rationale in the Supreme Court opinions. The *Flannery* approach was to contain, limit, and confine the Supreme Court decisions to the smallest possible area, disregarding the Court's legal reasoning, and then to announce a broad and expansive rule for situations or provisions not explicitly resolved in the earlier Court cases. The results were interpretations of the main anti-fraud provisions of the Securities Act and the Exchange Act that are at least in tension with if not direct affronts to decisions of the Supreme Court.

The details bear this larger criticism out. The Commission's position is that Rule 10b-5(a) and Rule 10b-5(c) impose primary liability on a person who drafts or devises a fraudulent misstatement to investors, who approves or decides not to revise a misleading statement, or who falsifies financial records to misstate a company's performance.¹⁴⁰ This under-

¹³⁹ See text accompanying notes 77-109 supra.

¹⁴⁰ The Commission did not explain what it meant by "devise," but it might have intended "create," "plan," "contrive," "invent," and "plot." See 1 New Shorter Oxford Eng-

standing of Rule 10b-5(a) and (c) resembles the broad standard for primary liability the SEC urged the Supreme Court to adopt in *Janus*, which would have reached a person that created or drafted a statement or that provided false or misleading information that another person then put into the statement.

The Commission's view of Rule 10b-5(a) and (c) also reaches a person who orchestrates sham transactions designed to give the false appearance of business operations even if a material misstatement by another person creates the nexus between the scheme and the securities market. This interpretation resembles the standard for primary liability that the SEC had urged on the court in *AOL* and that the plaintiffs picked up and advanced in *Stoneridge*. The SEC argument in *AOL* was that a person committed a primary violation when it engaged in a transaction whose principal purpose and effect was to create a false appearance of fact that, through one or more links in a causal chain, flowed to an investor even though another person was a subsequent link in the causal chain leading to a securities transaction.¹⁴¹

The Supreme Court rejected these legal standards in *Janus* and *Stoneridge*. *Janus* held that a person working on a public disclosure was not the primary actor when another independent person issued and had final say about the disclosure. This meant that, when a separate person had ultimate authority and control over a false or misleading statement, primary liability did not extend to a person who drafted, created, prepared, reviewed, approved, caused, or facilitated or substantially participated or assisted in a false or misleading statement.¹⁴² The outcome of *Stoneridge* was that a person entering into a transaction with a public company, even a deceptive transaction, that resulted in the public company's disclosure of false financial information was not a primary actor when the public company was independent and had final say about its disclosures.

lish Dictionary 656 (def. 3) (1993); Webster's Third New International Dictionary 619 (def. 1) (1976).

¹⁴¹ See text accompanying notes 73-74 *supra*.

¹⁴² *Janus* abrogated the much broader tests for primary liability applied in various lower courts. See, e.g., *SEC v. Wolfson*, 539 F.3d 1249, 1261 (10th Cir. 2008) ("We thus hold that because Marple [a consultant to the company that issued the challenged disclosures] caused the misstatements and omissions to be made, and knew that the statements were calculated to reach investors, defendants can properly be held liable under § 10(b) and § 17(a) for those misstatements and omissions."); *McConville v. SEC*, 465 F.3d 780, 787-88 (7th Cir. 2006) (defendant primarily liable as a cause because she drafted, reviewed, and approved false financial statements); *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) ("substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements.").

The essential lesson of *Janus*, *Stoneridge*, and *Central Bank* was that primary liability under Rule 10b-5 must be closely and directly tethered to a false or misleading statement or an action that deceived a securities offeree, buyer, or seller. Both *Janus* and *Stoneridge* emphasized the legal responsibility of the person with the final control and authority over the content and use of a communication to the investing public, as the appellate panel in *Fezzani* recognized.¹⁴³ When that person is separate and independent and is not obliged to follow instructions from another, that person and not others has primary exposure. *Stoneridge* conveyed this limitation with a proximate cause analysis that relied on concepts of remoteness, lack of control, and intervening independent acts. *Janus* conveyed the limitation with an emphasis on “ultimate authority,” “control,” and “the decision of an independent entity.”

The majority opinions in both *Stoneridge* and *Janus* taught that more expansive primary liability theories under an anti-fraud provision of the securities laws had legal and policy objections and erased the line between a primary violation and aiding and abetting. *Janus* said it intended to “draw a clean line between” those who are primarily liable and those who are secondarily liable.¹⁴⁴

The Commission’s interpretations of Rule 10b-5(a) and (c) extended primary liability to peripheral actors beyond limits the Supreme Court identified in *Janus* and *Stoneridge*. In an effort to revivify legal standards the Commission had developed but the Court had rejected, *Flannery* disregarded the rationale of the Supreme Court decisions and the line between primary and secondary liability that *Central Bank* and Section 20(e) made consequential.

The concern about maintaining a proper separation between primary and secondary liability applies to each subpart of Rule 10b-5. *Flannery* acknowledged this but believed that its approach to Rule 10b-5(a) and (c) appropriately distinguished between primary and secondary liability. For the Commission, the line was engaging in a deceptive act. If a person falsified a document or participated in a sham transaction, even if the person was not the public company issuing a false disclosure, he would be primarily liable.¹⁴⁵

The difficulty for the Commission is that the Supreme Court and a group of court of appeals and district court decisions disagree. The Supreme Court disagreed in *Stoneridge*. The plaintiffs pressed for a theory of primary liability based on a deceptive act by a defendant, and the dissent would have adopted it, arguing that “that this case is critically different from *Central Bank* because the bank in that case did not engage in any

¹⁴³ *Fezzani v. Bear Stearns & Co.*, 716 F.3d 18, 25 (2d Cir. 2013).

¹⁴⁴ *Janus*, 131 S. Ct. at 2302 n.6.

¹⁴⁵ *Flannery* *15 n.73.

deceptive act and, therefore, did not *itself* violate § 10(b).¹⁴⁶ The *Stoneridge* majority accepted that the suppliers in that case engaged in deceptive acts when entering into contracts with Charter but held that deception was not sufficient for primary liability: “Were we to adopt this construction of § 10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress’ determination that this class of defendants should be pursued by the SEC and not by private litigants.”¹⁴⁷

Keeping primary misconduct distinct from aiding and abetting is essential and explains the decisions of the several lower federal courts, discussed in *Flannery*, that tolerated the use of Rules 10b-5(a) or (c) in lieu of Rule 10b-5(b) only when a “scheme” also encompasses conduct beyond misrepresentations or omissions.¹⁴⁸ The Commission in *Flannery* disagreed with those decisions, but they maintain “the Supreme Court’s sharp distinction between those who are primarily liable for engaging in deceptive conduct, and those who only aid and abet the primary violation of another.”¹⁴⁹

3. *Section 17(a)(1)*.

The mistakes continued in the *Flannery* majority’s discussion of Section 17(a). The Commission committed compound errors in construing Section 17(a)(1). It began by concluding that a defendant’s conduct does not need to be manipulative or deceptive to violate Section 17(a), although an investor would need to be actually or potentially defrauded for liability to exist.¹⁵⁰

The main reason the Commission decided that Section 17(a) does not require a defendant’s conduct to be manipulative or deceptive was that Section 10(b) of the Exchange Act refers to “any manipulative or deceptive device or contrivance” and Section 17(a) does not. *Flannery* cited two commentators to support its reading¹⁵¹ and disregarded several court of

¹⁴⁶ *Stoneridge*, 128 S. Ct. at 774, 775 (Stevens, J., dissenting).

¹⁴⁷ *Stoneridge*, 128 S. Ct. at 771.

¹⁴⁸ See text accompanying notes 118-20 *supra*.

¹⁴⁹ SEC v. Goldstone, 952 F. Supp. 2d 1060, 1235 (D.N.M. 2013).

¹⁵⁰ Commentators made the interesting observation that this Commission position would eliminate the “possibility of misappropriation theory insider trading under Section 17(a). This is so because the misappropriation theory is premised not on actual or even potential deception of investors, but rather on deception of the source of information in breach of a duty of confidentiality owed to that source.” Matthew Martens et al., “We Intend to Resolve the Ambiguities”: The SEC Issues Some Surprising Guidance on Fraud Liability in the Wake of *Janus*, 47 Sec. Reg. & L. Rep. 220, at 4 (February 2, 2015).

¹⁵¹ One authority the Commission cited as support for the statement that Section 17(a) does not require deception was the treatise by Professor Hazen, *Flannery* *16 n.84,

appeals decisions saying that the prohibitions in Section 17(a) and Rule 10b-5 are substantially identical.¹⁵² From this, the Commission concluded that Section 17(a) reached a defendant that contributed to a fraud through conduct that was not itself deceptive or manipulative.¹⁵³ This reading does not appear to be sound, and, if it is not, some of the Commission's interpretations of Section 17(a) render too much conduct a violation of law.

The Commission was correct that Section 10(b) of the Exchange Act refers to "any manipulative or deceptive device or contrivance" and Section 17(a) does not, but the Commission did not evaluate its conclusion specifically against the language of Section 17(a)(1). The words of subsection (1) do not support the Commission's reading and, to the contrary, appear to require that a defendant engage in manipulative or deceptive conduct.

Subsection (1) makes it unlawful "to employ any device, scheme, or artifice to defraud." The critical concept is an action to commit fraud, and the word fraud means both manipulation and deception. Black's Law Dictionary defines "defraud" as causing loss by deceit and refers to "fraud."¹⁵⁴ "Fraud" is a misrepresentation or concealment of a material fact or any kind of artifice by which another is deceived.¹⁵⁵ A deception is the act of deceiving.¹⁵⁶ To the Supreme Court, the other word, "manipulative," was a species of deceit or fraud: "It connotes intentional or willful conduct de-

but the treatise does not support the statement. The same section of the treatise debunks the position. The treatise cited reasons that support "a deception requirement in section 17(a), at least to the extent that there must be a material misstatement or omission." 4 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 12.22 at 469 (6th ed. 2009).

¹⁵² *Flannery* cited three decisions in note 79 on page *15. Other cases also equate the elements of a Rule 10b-5 violation and a Section 17(a) violation; the exceptions are that negligence is sufficient for a violation of Section 17(a)(2) and (3) and that Section 17(a) applies in the offer or sale of a security rather than in connection with a purchase or sale. See *SEC v. Pentagon Capital Management PLC*, 725 F.3d 279, 285 (2d Cir. 2013) ("The requirements for a violation of Section 17(a) apply only to a sale of securities but in other respects are the same as Section 10(b) and Rule 10b-5, except" for the different mental state requirements); *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1244 (11th Cir. 2012).

¹⁵³ *Flannery* *16.

¹⁵⁴ Black's Law Dictionary 516 (10th ed. 2014).

¹⁵⁵ *Id.* at 775.

¹⁵⁶ A deceptive act is conduct likely to deceive. A deception is an act deliberately causing someone to believe that something is true when the actor knows it to be false. *Id.* at 492. *Flannery* used similar definitions. It said "to employ a 'deceptive' device or to commit a 'deceptive' act is to engage in conduct that gives rise to a false appearance of fact" and referred to "dictionaries in use at the time Congress passed the Exchange Act that define 'deceptive' as 'having power to mislead' or '[t]ending to deceive,' and define 'deceive' as '[t]o cause to believe the false or to disbelieve the true.'" *Flannery* *12 n.52.

signed to deceive or defraud investors by controlling or artificially affecting the price of securities.”¹⁵⁷

The phrase “device or contrivance” in Section 10(b) does not convey a different idea from “device, scheme, or artifice” in Section 17(a)(1). In *Aaron*, the Supreme Court observed that “the terms ‘device,’ ‘scheme,’ and ‘artifice’ all connote knowing or intentional practices.”¹⁵⁸ It cited definitions from 1934 of “device,” “scheme,” and “artifice” demonstrating that they and the word “contrivance” were substantially similar and circled back on each other.¹⁵⁹ A contrivance is a deceitful practice or a method to bring to pass by planning, scheming, or stratagem.¹⁶⁰

The verb form in the subpart is “to employ.” The definition of “to employ” is to use as a means or instrument or to apply or devote a thing to some definite purpose.¹⁶¹ In *Hochfelder*, the Supreme Court noted that the word “employ,” which appears in both Section 17(a)(1) and Section 10(b), indicated congressional intent to impose liability only when conduct was more than negligent.¹⁶²

Thus subsection (1) of Section 17(a) is aimed at active and conscious use of deceit, deception, or manipulation in a securities offer or sale. Seeing a gap between the language of subpart (1) of Section 17(a) and the phrase “manipulative or deceptive device or contrivance” in Section 10(b) is difficult. A proper interpretation of Section 17(a)(1) should require that a defendant’s conduct be manipulative or deceptive.

That mistake led the Commission to conclude that a defendant could have primary liability under Section 17(a)(1) by contributing to a fraud through conduct that is not itself deceptive or manipulative.¹⁶³ The Commission’s example was a person who entered into a legitimate, non-deceptive transaction with a reporting company and who knew that the public company planned to misstate the revenue. This conclusion has several defects. It is disconnected from the statutory language requiring a defendant to commit fraud. Even the dissent in *Stoneridge* believed that a deception was necessary for a primary violation of Rule 10b-5, although

¹⁵⁷ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).

¹⁵⁸ Aaron v. SEC, 446 U.S. 680, 696 (1980).

¹⁵⁹ For example, the definition of “device” was something “devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice.” *Id.* at 696 n.13. An “artifice” was a crafty device. *Id.* See also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976).

¹⁶⁰ 2 Oxford English Dictionary 926 (def. 1) (1933).

¹⁶¹ 4 Oxford English Dictionary 129-30 (def. 1) (1933). Webster's New Int'l Dictionary 839 (2d ed. 1934) (“employ” is to “make use of, as an instrument, means, or material”).

¹⁶² Hochfelder, 425 U.S. at 199 n.20.

¹⁶³ Flannery *16, *18.

the majority's position was that a deceptive act was not necessarily sufficient by itself for primary liability.¹⁶⁴ Section 17(a)(1)'s demand that a defendant employ an artifice to defraud requires no less. Engaging in a legitimate, non-deceptive action is not fraud.

Labeling a person who entered into a legitimate, non-deceptive transaction as a primary violator of Section 17(a)(1) is also inconsistent with the need to prove scienter. The Supreme Court's definition of scienter for Section 17(a)(1) is closely tied to the defendant's own fraudulent conduct; it is "an intent on the part of the defendant to deceive, manipulate, or defraud."¹⁶⁵ A defendant does not intend his conduct to deceive when he enters into a legitimate, non-deceptive transaction. Knowledge about a different person's intent is not a substitute for the defendant's own intent, and the Supreme Court was explicit that the defendant have the intent to deceive. The mental state element of a primary violation must be attached to the defendant's own conduct, not the conduct of another person, yet the Commission would find the scienter element satisfied if a defendant knew another person planned to commit a fraud. That is the classic description of part of the mental state needed for an aiding and abetting violation.¹⁶⁶

As a result, the Commission's construction of Section 17(a)(1) is doubly extreme. According to the Commission, a person could violate Section 17(a)(1) when he engaged in a lawful, non-deceptive (possibly even socially beneficial) transaction and had no culpability about his own actions, which were legitimate in any event. The Commission would sanction such a person as a primary violator for having knowledge (or recklessness, no doubt) about a third party's intent.¹⁶⁷ Such an outcome does not seem to be well-founded on the authorities.

The Commission also read Section 17(a)(1) congruently with Rule 10b-5(a) and (c) to reach "all scienter-based, misstatement-related misconduct": a person who makes a misstatement as well as one who drafts or devises a misstatement or uses a misstatement made by others to de-

¹⁶⁴ See text and accompanying note 86 supra.

¹⁶⁵ Aaron, 446 U.S. at 686 & n.5; see also Hochfelder, 425 U.S. at 193 n.12.

¹⁶⁶ See, e.g., SEC v. Goble, 682 F.3d 934, 947 (11th Cir. 2012) (knowledge of the primary violation); SEC v. Shanahan, 646 F.3d 536, 547 (8th Cir. 2011) (knowledge of the primary violation); SEC v. DiBella, 587 F.3d 553, 566 (2d Cir. 2009) (knowledge of the primary violation). In some jurisdictions, the SEC also must prove that the defendant participated in the primary violation as something that he wished to bring about and make successful. SEC v. Apuzzo, 689 F.3d 204, 212 (2d Cir. 2012).

¹⁶⁷ Moreover, under traditional U.S. criminal law, a vicious will or a bad thought by itself and with no unacceptable conduct is not a violation of law. 1 Wayne R. LaFare, Substantive Criminal Law § 6.1, at 422 (2d ed. 2003) ("Bad thoughts alone cannot constitute a crime.").

fraud investors. In each case, the Commission claimed, the person employed a device or artifice to defraud.¹⁶⁸

The principal reason to question interpretations of Section 17(a)(1) that cover a person creating, drafting, devising, reviewing, approving, or using a misstatement is the same as the main weakness in the Commission's construction of Rule 10b-5(a) and (c).¹⁶⁹ The *Flannery* interpretation of Section 17(a)(1) resurrects the standard that the Commission forwarded and the Supreme Court rejected in *Janus* and obscures the difference between primary and secondary conduct. *Janus*, in conjunction with *Central Bank* and *Stoneridge*, instructed that primary liability should not sweep too broadly and should capture only the person with ultimate authority and responsibility for a deception. The primary reasons for that limitation apply to Section 17(a)(1).¹⁷⁰ Of course, the Commission was right that *Janus* concentrated on Rule 10b-5(b) and the word "make," and maybe the Court meant to go no further. Then again, that might not be the better reading, as preceding sections of this article attempted to explain.

The Commission's failure to heed the Supreme Court's efforts to curtail primary liability under the main anti-fraud provision of the federal securities laws is also the principal critique of the Commission's reading of the remainder of Section 17(a): Section 17(a)(2) and (3). Nonetheless, a few specific comments about the Commission's treatment of Section 17(a)(2) and (3) will be useful.

4. *Section 17(a)(2)*.

The *Flannery* construction of Section 17(a)(2) continued the growing coverage of primary liability. The Commission majority determined that the "use" of a misstatement to obtain money or property satisfies the phrase "by means of" in Section 17(a)(2). The First Circuit and other courts reached a similar decision.¹⁷¹ *Flannery* said all that is necessary is

¹⁶⁸ *Flannery* *17.

¹⁶⁹ See text accompanying notes 139-49 supra.

¹⁷⁰ One difference between Rule 10b-5 and Section 17(a) that affects the transferability of the reasoning in *Janus* and *Stoneridge* is that no private right of action for a Section 17(a) claim exists, or at least that is the consensus of the courts of appeals. See, e.g., *Maldonado v. Dominguez*, 137 F.3d 1, 6-8 (1st Cir. 1998); *Finkel v. Stratton Corp.*, 962 F.2d 169, 174-75 (2d Cir. 1992); *Bath v. Bushkin, Gaims, Gaines & Jonas*, 913 F.2d 817, 819 (10th Cir. 1990). That the courts implied the private right of action under Rule 10b-5 was a reason for the narrow results in both *Janus* and *Stoneridge*. *Janus*, 131 S. Ct. at 2303; *Stoneridge*, 552 U.S. at 167. That one factor does not seem sufficient to offset the applicability to Section 17(a) of the other portions of the opinions in *Janus* and *Stoneridge*.

¹⁷¹ See *SEC v. Tambone*, 597 F.3d 436, 444, 450 (1st Cir. 2010) (en banc) (court compared the language of Section 17(a)(2) and Rule 10b-5(b) and concluded that "Section 17(a)(2) may fairly be read to cover the 'use' of an untrue statement to obtain money or property," but Rule 10b-5(b) does not extend that far; the court also reinstated the original panel decision on Section 17(a)(2)); *SEC v. Tambone*, 550 F.3d 106, 120-23, 127-28

“a causal link between the misrepresentation and the acquisition of money or property”: “a misrepresentation must be at least relevant to, if not the cause of, the transfer of money or property from an investor to the defendant” or his employer.¹⁷² The Commission did not explain what it meant by a misrepresentation being “relevant to” a transfer of money.¹⁷³ It did not otherwise specify what the word “use” meant except to say that it covered a broader range of activity than making a false statement and that a person could use a misstatement without making it.

The relevance or but-for causation tests seemed to spring from nowhere and are troubling for several reasons. They would apply to long chains of conduct¹⁷⁴ and therefore to many potential defendants, yet an exorbitant causation doctrine is the antithesis of the close connections and proximate cause analysis the Court used for primary liability in *Stoneridge* and *Janus*. The tests are not sufficiently tied to the concept of “use” that the Commission adopted. In other statutory contexts, the Supreme Court imposed a limiting construction on “use”: “Use” signifies “active employment” and “action and implementation.”¹⁷⁵ These concepts imply a close relationship among a misstatement, a defendant’s conduct, and the defendant’s acquisition of money or property.

The Commission majority also turned a blind eye to the analysis of statutory language closely similar to Section 17(a)(2) in a recent Supreme Court decision even though the Commissioners were aware of and cited the decision. The decision, *Loughrin v. United States*, involved the federal bank fraud statute, which makes it unlawful to “obtain money or property” from a bank “by means of” a false representation.¹⁷⁶ Loughrin forged checks to buy goods from Target and then returned the goods to Target for cash. He argued that he intended to defraud Target but not a bank and

(1st Cir. 2008) (court compared Section 17(a) and Rule 10b-5 and found that liability under Section 17(a)(2) attaches when a defendant uses a false statement to obtain money or property whether the defendant or another person made the statement); *Flannery* *11 n.38. See also text accompanying note 121 supra.

¹⁷² *Flannery* *25.

¹⁷³ Black’s Law Dictionary 1481 (10th ed. 2014) defines “relevant” as logically connected and tending to prove or disprove a matter in issue; having appreciable probative value – that is, rationally tending to persuade people of the probability or possibility of some alleged fact.

¹⁷⁴ 1 Dan B. Dobbs, et al., *The Law of Torts* 684 (2d ed. 2011) (without scope limits, liability based on factual causation “would go on forever”); 4 Fowler V. Harper et al., *Harper, James and Gray on Torts* § 20.1, at 94 (3d ed. 2007) (under cause in fact, “the scope of liability would be vast indeed”; the causes of causes are infinite).

¹⁷⁵ *Jones v. United States*, 529 U.S. 848, 855 (2000); *Bailey v. United States*, 516 U.S. 137, 143, 145 (1995) (“use” implies “action and implementation”; the “ ‘ordinary or natural’ meaning” of “use” is “ ‘to convert to one’s service’ ” or “ ‘to avail oneself of,’ and ‘to carry out a purpose or action by means of.’ ”).

¹⁷⁶ 134 S. Ct. 2384, 2394 (2014).

was not covered by the statute. Applying the statute to him, he said, would mean it applied to any state-law fraud involving a check.¹⁷⁷ The Court concluded that the statute covered Loughrin's conduct but not every fraud involving a check: The acquisition of money must be "by means of" or through a fraud or misrepresentation, and the connection between the two must be more than "oblique, indirect, and incidental." Not "every but-for cause will do."¹⁷⁸ The "'means' component ... imposes certain inherent limits on its reach."¹⁷⁹ The Supreme Court held that one obtains money or property from a bank "by means of" a false statement only if "the defendant's false statement is the mechanism naturally inducing a bank ... to part with money in its control."¹⁸⁰ The false statement must go to the financial institution for the fraud to be the means of obtaining bank property.¹⁸¹

Not everything about the bank fraud statute is identical to Section 17(a)(2), but *Loughrin* still raises questions about the SEC's wide interpretation of "by means of" in the securities provision. *Flannery* adopted a "causal link" or relevance test, but the Supreme Court expressly rejected such a long reach for the bank fraud statute. But-for causation would not do, and the connection between obtaining money and the false statement needed to be more than oblique, indirect, or incidental. The connection between the misrepresentation and the transfer of money or property must be much closer than just relevance or causation.

At the same time, the Court did not require a defendant to submit a false statement directly to a financial institution. Loughrin submitted the forged checks to a retailer, but that difference was not meaningful. "After all, a merchant accepts a check only to pass it along to a bank for payment; and upon receipt from the merchant, that check triggers the disbursement of bank funds just as if presented by the fraudster himself."¹⁸² The false statement of the defendant must and did go the bank. It would not have been sufficient for the false statement to have gone to a third party who then separately and independently deceived a bank to obtain money. No question came up in *Loughrin* about the identity of the person with ultimate authority or control over the false statement. That was the defendant.¹⁸³

¹⁷⁷ Id. at 2392.

¹⁷⁸ Id. at 2393.

¹⁷⁹ Id. at 2389.

¹⁸⁰ Id.

¹⁸¹ Id. at 2394.

¹⁸² Id. at 2393.

¹⁸³ See generally Matthew T. Martens & Mark D. Cahn, Unnoticed Supreme Court Decision Could Narrow Securities Fraud Law Enforcement, Bloomberg BNA, Sec. L. Daily (Aug. 4, 2014) ("the Loughrin Court's interpretation of the relevant language would require, for purposes of Section 17(a)(2), that a false statement reach the buyer of securities,

5. *Section 17(a)(3).*

The Commission laid out its most extreme scope of coverage for Section 17(a)(3). Under Section 17(a)(3), no person may “engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” According to the Commission, the provision does not require a defendant to have engaged in conduct that is deceptive and, consistent with *Aaron*, does not require proof of scienter. It applies when, “as a result of a defendant's negligent conduct, investors receive misleading information about the nature of an investment or an issuer's financial condition” or, “as a result of a defendant's negligence, prospective investors are prevented from learning material information about a securities offering.”¹⁸⁴ A defendant engages in a practice or course of business with two or more culpable acts.¹⁸⁵

The meaning of the substantive prohibition in Section 17(a)(3) has not received much attention in the courts. Most of the discussion of Section 17(a)(3) has been about the absence of a scienter requirement.¹⁸⁶ More recently, courts have discussed the applicability of *Janus* to Section 17(a).¹⁸⁷

The Commission's approach does not provide much further clarification except to create an enormous category of potential defendants. Keep in mind that the Commission reserved on whether it needed to prove a defendant's negligence to support a Section 17(a)(2) or (3) claim.¹⁸⁸ The only boundary on the SEC's use of Section 17(a)(3) is that a defendant's conduct must “result” in an investor receiving misleading information or being prevented from receiving material information. That is a but-for or factual causation test that is commonly recognized to be nearly limitless¹⁸⁹ and that does not sit well with the limiting constructions in *Stoneridge* and *Janus*. The Commission's standard would reach a clerk who mistakenly put an early date on his employer's purchase order and allowed a publicly reporting counterparty supplying the product to disclose revenue a

that the false statement be ‘the mechanism naturally inducing’ the buyer of securities ‘to part with money,’ and that the money with which the buyer parted then reach, at least indirectly, the fraudster.”)

¹⁸⁴ *Flannery* *18.

¹⁸⁵ *Id.* *25.

¹⁸⁶ See *Aaron v. SEC*, 446 U.S. 680, 697 (1980) (the language of Section 17(a)(3) quite plainly focuses upon the *effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible.”); cases cited note 152 *supra*.

¹⁸⁷ See *SEC v. Stoker*, 865 F. Supp. 2d 457 (S.D.N.Y. 2012) (considering whether *Janus* applied to Section 17(a)).

¹⁸⁸ *Flannery* *10 n.30.

¹⁸⁹ See text and accompanying note 174 *supra*.

quarter before the appropriate period. It would reach an employee's internal research memorandum on a potential new product if the employee materially underestimated the size of the market so developments about the new product were not disclosed. It would reach an employee of a software firm who made an error in a computer program sold on the open market and used by a public company to collect information discussed in a report to investors. Whatever you might think of these different situations and the need for legal liability, they are not securities fraud.

The Commission said Section 17(a)(3) covered conduct that prevented an investor from receiving material information. It did not qualify this assertion by adding that the actor (or some person in the causal chain) would need to have a duty to disclose arising from a source other than Section 17(a) or would need to have made an affirmative statement requiring further information to make the statement not misleading. Thus, the Commission would impose liability under Section 17(a)(3) for silence or a pure omission with no corresponding duty to disclose. This standard in essence imposes a duty to disclose all material information on each and every person who is a but-for cause of a disclosure to an investor. That concept is difficult to comprehend and would be even more difficult to administer or implement in a compliance program. Individuals would not always know when they were in a chain leading to some disclosure to an investor and would not always know what information they had that would matter to an investor; an individual in the middle of a chain would need to receive all the disclosures from those earlier in the chain, aggregate them with his own material information to the extent he could identify it, and then pass that growing package on down the chain towards an investor.

The anti-fraud provisions have not traditionally been interpreted this broadly, and the Supreme Court has refused to find a duty to disclose material information under Rule 10b-5: "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."¹⁹⁰

6. *Summary of concerns with the Flannery legal conclusions.*

This discussion of the *Flannery* legal conclusions and recent Supreme Court and court of appeals decisions yields these major concerns:

- Several interpretations in *Flannery* sought to over-rule *Stoneridge* by applying an anti-fraud provision to a person in the position of the suppliers held not liable in *Stoneridge*. The Commission would apply Rule 10b-5(a) and (c) and Section 17(a)(1) to a person who orchestrates a

¹⁹⁰ Chiarella v. United States, 445 U.S. 222, 233, 235 (1980). See also United States v. Newman, 773 F.3d 438, 445, 449 (2d Cir. 2014).

sham transaction designed to give a false appearance even if a different person knowingly makes a false public disclosure as a result of the sham transaction.

- Several interpretations sought to over-rule *Janus* by applying an anti-fraud provision to a person in the position of the adviser held not liable in *Janus*. The Commission would apply Rule 10b-5(a) and (c) and Section 17(a)(1) to a person who drafts, approves, or decides not to revise a misstatement.
- The Commission interpretation of Rule 10b-5(a) and (c) and each subsection of Section 17(a) has wide and extended coverage that blurs the difference between a person with primary liability and an aider and abettor. Take, for instance, the case of a Vice President at a purchasing company that paid for and accepted delivery of products when the Vice President had a secret agreement with the CFO of the selling company that the products could be returned for a full refund and the Vice President also knew that the CFO of the selling company, which is a publicly reporting company, wrongly included the sales revenue in the selling company's financial statements. The Vice President certainly helped the CFO and the selling company and could be an aider and abettor, but did the Vice President commit a primary violation of the securities anti-fraud laws? The Commission would hold the Vice President responsible for a primary violation even though his actions were several steps removed from the preparation of the financial statements or public disclosures of the selling company and even though the selling company and its CFO knew all the facts and had complete and independent control over the financial statements and public disclosures.
- The Commission interpretation of Section 17(a)(1) does not require manipulation or deception, but the words of the provision do not support this conclusion. The words require a defendant to take active steps to defraud, and a fraud is a deception or manipulation.
- The Commission interpretation of Section 17(a)(1) would impose liability on a person who engaged in a lawful, non-deceptive transaction and had no culpable mental state about his own conduct. That outcome is not consistent with the language of Section 17(a)(1), existing legal authority, or sound legal analysis.
- The Commission adopted a test for liability under Section 17(a)(2) based on but-for or possibly even broader causation. This nearly unlimited scope of coverage for an anti-fraud provision contradicts the Supreme Court's construction of similar prohibitions.
- The Commission interpretation of Section 17(a)(3) would break new ground by imposing liability for silence or a failure to disclose without the need for proof of a duty to disclose the omitted information.

III. **JUDICIAL DEFERENCE TO SEC LEGAL INTERPRETATIONS IN AN ADJUDICATION.**

A second major question from *Flannery* is whether courts should accept its legal interpretations as conclusive or otherwise should defer to them in some way. *Flannery* made an explicit call for judicial deference to its legal conclusions as an expert agency. The SEC did not just want to add its voice to the debate among the courts about the meaning of the subparts of Section 17(a) and Rule 10b-5; it wanted to silence and win the debate. The majority explicitly said it intended to resolve the issues. My objective in this Part is to evaluate that claim to dominance.

This Part covers several points. It begins by explaining that *Flannery* is an administrative adjudication, the types of adjudications the SEC handles, the process the SEC follows to render an adjudication decision, and the four main standards a court could use to review the SEC decision. Next, we will see that, in *Flannery*, the SEC claimed the most deferential standard of judicial review available, *Chevron* deference. The sections after that discuss the application of *Chevron* deference to legal conclusions in an agency adjudication and to an agency's interpretation of its own rules. The final section reviews the main grounds a court would have for not according *Chevron* deference to the Commission's legal interpretations of the subparts of Section 17(a) and Rule 10b-5 in *Flannery*.

A. **SEC Adjudications and Possible Standards for Judicial Review.**

To set the stage for this discussion, we should address a few preliminary matters. They are to describe the type of agency action the SEC took in *Flannery* – an adjudication – and place it in the context of administrative law. Part of this description will be of the process the SEC Commissioners follow to reach a decision in a case like *Flannery*. Another preliminary matter will be to outline the possible standards a court could apply to review the legal pronouncements in *Flannery*.

Flannery was a formal adjudication in a contested enforcement proceeding brought by the SEC within the SEC's administrative system.¹⁹¹

¹⁹¹ An adjudication under 5 U.S.C. § 551(7) is an “agency process for the formulation of an order” and under 5 U.S.C. § 554(a) is one “required by statute to be determined on the record after opportunity for an agency hearing.” The Commission may discipline a registered or associated person if it makes certain findings “on the record after notice and opportunity for hearing,” e.g., section 15(b)(4), (6) of the Exchange Act, 15 U.S.C. § 78o(b)(4), (6), impose a civil monetary penalty in an administrative proceeding if it makes certain findings “on the record after notice and opportunity for hearing,” section 21B(a)(1), (2) of the Exchange Act, 15 U.S.C. § 78u-2(a)(1), (2), issue a cease and desist order if it makes certain findings “after notice and opportunity for hearing,” section 21C(a) of the Exchange Act, 15 U.S.C. § 78u-3(a), and affirm or modify disciplinary sanctions imposed by a self-regulatory organization “after notice and opportunity for hearing,” section 19(e) of the Exchange Act, 15 U.S.C. § 78s(e). Section 21 of the Securities

It involved an adversarial proceeding resembling litigation in federal court to resolve an SEC charge that the defendants committed securities law violations. The proceeding was not a formal rulemaking or a notice-and-comment rulemaking. It was not a rate-making, a licensing, an interpretative rule, a statement of policy, a brief filed in court in litigation in which the SEC was a party, an amicus brief, an internal advice memorandum, or staff guidance.

The Commission handles several types of adjudications. It reviews ALJ decisions in administrative enforcement proceedings,¹⁹² as it did in *Flannery*. The Commission also determines whether to discipline regulated entities and persons associated with those entities. For example, the Commission may revoke the registration of a broker-dealer or bar an individual from being associated with a broker dealer.¹⁹³ Finally, the Commission reviews enforcement decisions of various self-regulatory organizations, such as the regulatory organization for broker-dealers, and the Public Company Accounting Oversight Board.¹⁹⁴ The SEC Rules of Practice are the procedural rules governing adjudications.¹⁹⁵

The *Flannery* proceeding began when the Commissioners voted to charge Flannery and Hopkins with violations of the securities laws based on allegations of specific misconduct. The SEC may initiate an enforcement case in federal district court or in an administrative proceeding¹⁹⁶ and decided to sue Flannery and Hopkins in an administrative proceeding. An administrative law judge held a trial-type hearing on the record and issued an initial decision with findings of fact and conclusions of law. The Commission reviewed the ALJ decision with briefing and oral argument from representatives of the Division of Enforcement and the private parties. The Commission then issued an opinion substantially resembling a court decision.

The SEC has an established internal process to prepare an adjudication decision. A group within the Office of the General Counsel, the Adjudication Group, prepares drafts of an adjudication opinion for the Commissioners.¹⁹⁷ A lawyer on the personal staff of each Commissioner, called

Act, 15 U.S.C. § 77u, and section 22 of the Exchange Act, 15 U.S.C. § 78v, require an appropriate record of a hearing. In an SEC administrative proceeding, the ALJ and the Commission must determine the matter on the basis of the record. 17 C.F.R. §§ 201.360(b), 201.460.

¹⁹² A typical example is a cease and desist proceeding under section 21C(a) of the Exchange Act, 15 U.S.C. § 78u-3(a).

¹⁹³ 15 U.S.C. § 78o(b)(4), (b)(6).

¹⁹⁴ 15 U.S.C. §§ 78s(d)(2), 7217(c)(2).

¹⁹⁵ 17 C.F.R. §§ 201.100 through 201.1005.

¹⁹⁶ See 15 U.S.C. §§ 78u(d)(1), 78u-3(a)-(b); 17 C.F.R. § 202.5(b).

¹⁹⁷ See SEC website, Office of the General Counsel, About the Office, available at <http://www.sec.gov/ogc>.

a counsel, reviews the drafts, briefs the Commissioner, and provides comments to the Adjudication Group. The Commissioners typically read all or part of a draft, then discuss a draft at a closed meeting, and vote to approve or disapprove it. If a decision is approved and the defendant is not happy, he may petition for review in a court of appeals.¹⁹⁸

As a broad generality, a court may apply one of four main standards when reviewing agency action.¹⁹⁹ Variations exist, but these four basic standards will serve our purposes.

- One is to give the agency result no deference at all on law, facts, or anything else. The court reaches its own conclusion on the best, most accurate outcome even if an agency choice was reasonable. This is generally called *de novo* review.²⁰⁰ A reviewing court is highly unlikely to engage in a *de novo* evaluation of facts in an adjudication, and, in SEC adjudications, the Exchange Act provides that factual findings of the Commission are conclusive if supported by substantial evidence.²⁰¹
- The second standard of review is to accept an agency position if its reasoning was persuasive.²⁰²
- The third is *Chevron* deference, which gives agency positions “controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.”²⁰³ The essence of the *Chevron* rule is that “[s]tatutory ambiguities will be resolved, within the bounds of reasonable interpretation, not by the courts but by the administering agency.”²⁰⁴ Under *Chevron*, a reasonable agency choice binds a court even if the court believes a different result would be better. An important strand in *Chevron* deference cases is recognition that, on many issues, an agency has expertise and experience.²⁰⁵
- The fourth standard comes from the statutory text in the Administrative Procedure Act governing judicial review of agency action. A re-

¹⁹⁸ 15 U.S.C. § 78y(a)(1). Flannery and Hopkins petitioned the First Circuit for review of the SEC decision.

¹⁹⁹ See Gary Lawson, *Federal Administrative Law* 457-60 (6th ed. 2013) (discussing standards of review).

²⁰⁰ See David Zaring, *Reasonable Agencies*, 96 Va. L. Rev. 135, 144 (2010).

²⁰¹ 15 U.S.C. § 78y(a)(4).

²⁰² See *United States v. Mead*, 533 U.S. 218 (2001); *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

²⁰³ *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984); see also *Mead*, 533 U.S. at 227.

²⁰⁴ *City of Arlington, Tex. v. FCC*, 133 S. Ct. 1863, 1868 (2013).

²⁰⁵ *National Cable & Telecommunications Assn. v. Brand X Internet Services*, 545 U.S. 967, 1002-03 (2005); *Barnhart v. Walton*, 535 U.S. 212, 222 (2002); *Chevron*, 467 U.S. at 865.

viewing court must “hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” or “in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.”²⁰⁶ As the quotation about the *Chevron* standard demonstrates, courts tend to treat the APA standard as independent of and in addition to *Chevron* deference questions, but the relationship between the two is the subject of debate.²⁰⁷

B. ***Flannery’s Claim to Chevron Deference.***

The *Flannery* majority made an overt bid for complete judicial deference to its legal conclusions as an expert agency. It did not cite *Chevron*, but it muscled into the legal discussion with this introduction:

[W]e recognize the ambiguity in Section 10(b), Rule 10b-5, and Section 17(a). Further, we note that, to date, Commission opinions have provided relatively little interpretive guidance regarding the meaning and interrelationship of these provisions. By setting out our interpretation of these provisions—which is informed by our experience and expertise in administering the securities laws—we intend to resolve the ambiguities in the meaning of Rule 10b-5 and Section 17(a) that have produced confusion in the courts and inconsistencies across jurisdictions.²⁰⁸

The *Flannery* majority left no doubt it was claiming that courts should defer to its expertise and experience. All the language cries out for *Chevron* deference: the reference to ambiguous legal provisions, the assertion of experience and expertise in administering the securities laws, the ability to be a source of interpretive guidance, and the need for the SEC’s interpretation to resolve the ambiguities.

Actions by the SEC staff confirm this reading of the *Flannery* passage. While an SEC enforcement case was on appeal in the Eleventh Circuit, the staff notified the court of appeals about the *Flannery* decision and the parts of *Flannery* supporting the SEC’s arguments in the case on appeal. The staff informed the court that the *Flannery* interpretations were controlling under *Chevron*.²⁰⁹ The court’s later opinion in the case cited *Flannery* as support.²¹⁰

²⁰⁶ 5 U.S.C. § 706(2)(A), (C).

²⁰⁷ See text accompanying note 224 *infra*.

²⁰⁸ *Flannery* *9.

²⁰⁹ SEC letter of supplemental authority at 1, *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786 (11th Cir. 2015) (No. 13-11976).

²¹⁰ See *Big Apple Consulting USA, Inc.*, 783 F.3d at 797.

C. **Judicial Standards for Reviewing Legal Conclusions in an Agency Adjudication.**

How should a court react to the SEC's claim for deference to legal interpretations of Section 17(a) and Rule 10b-5 in an adjudication of enforcement charges the agency itself leveled? Answering that question is not an easy task. The case law and scholarly commentary guiding judicial review of agency actions are extensive,²¹¹ but the picture they build up is not in high definition. The legal authorities are unpredictable and inconsistent. Administrative law scholars have said that the Supreme Court applies *Chevron* in "strange and inconsistent ways" and with "little doctrinal consistency."²¹²

As a result, reaching a confident and definitive answer to whether a court should give controlling or influential weight to *Flannery's* legal conclusions about the meaning of the different parts of Section 17(a) and Rule 10b-5 is not possible. What is possible based on existing law is to say with some confidence that a reviewing court would have precedential and doctrinal grounds for rejecting the Commission's attempt to obtain complete deference to the legal analysis in *Flannery*, for reviewing that analysis against the standards in section 706(2) of the APA, and for treating the analysis as influential only to the extent its reasoning persuades.

Below are several reasons for not granting *Chevron* deference to the legal interpretations in *Flannery*. A reviewing court certainly should not feel constrained by the agency's demand for deference.²¹³

²¹¹ See, e.g., Stephen G. Breyer et al., *Administrative Law and Regulatory Policy* 282-385 (7th ed. 2011); Gary Lawson, *Federal Administrative Law* 532-801 (6th ed. 2013) (the implementation of *Chevron* "has generated an enormous range of problems" and "an enormous body of case law and academic commentary" (551); "*Chevron* is without a doubt the most controversial doctrine in modern administrative law. The scholarly literature on *Chevron*, both pro and con, is voluminous" (685)); Caleb Nelson, *Statutory Interpretation* 689-776 (2011); 1 Richard J. Pierce, Jr., *Administrative Law Treatise* 155-273 (5th ed. 2010); Peter L. Strauss et al., *Gellhorn & Byse's Administrative Law* 976-1189 (11th ed. 2011).

²¹² 1 Richard J. Pierce, Jr., *Administrative Law Treatise* 221-22 (5th ed. 2010) ("The Supreme Court has not been consistent and conscientious in applying *Chevron*. ... Sometimes it gives *Chevron* powerful effect, sometimes it ignores *Chevron*, and sometimes it characterizes the *Chevron* test in strange and inconsistent ways."); William N. Eskridge, Jr. & Lauren E. Baer, *The Continuum of Deference: Supreme Court Treatment of Agency Statutory Interpretations from *Chevron* to *Hamdan**, 96 *Geo. L.J.* 1083, 1089-91 (2008) (authors examined over 1000 Supreme Court cases in which an agency interpretation of a statute was an issue; in over 50 percent of the cases, the Court did not apply any deference regime at all; the Court usually did not apply *Chevron* when it could; the Court's application of *Chevron* had "little doctrinal consistency").

²¹³ Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain*, 89 *Geo. L.J.* 833, 910 (2001) ("it has never been maintained that Congress would want courts to give *Chevron* deference to an agency's determination that it is entitled to *Chevron* deference").

1. *APA standard.*

One reason is Congress's command that "the reviewing court shall decide all relevant questions of law." The Exchange Act does not specify a standard for reviewing questions of law,²¹⁴ but the Administrative Procedure Act fills in that gap with Section 706: "To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action." A reviewing court must "hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" or "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right."²¹⁵ These provisions admit no deference on legal questions, and the Supreme Court recently admonished that reviewing courts should stick closely to the statutory text of the Administrative Procedure Act.²¹⁶ In some circumstances, such as when the agency action is closer to the legal interpretation end of the spectrum, *Chevron* could be seen to conflict with these statutory commands.²¹⁷

2. *Practice of the Supreme Court in reviewing legal conclusions in an agency adjudication.*

A second reason a court should not feel obliged to apply *Chevron* deference to legal interpretations in an agency adjudication is that the Supreme Court has not invariably done so. The Supreme Court has said that *Chevron* deference applies to an agency adjudication,²¹⁸ but it has not al-

²¹⁴ Section 25(a)(4) of the Exchange Act provides that a court reviewing a final order of the Commission must accept factual findings supported by substantial evidence but is silent on questions of law. 15 U.S.C. § 78y(a)(4).

²¹⁵ 5 U.S.C. § 706(2)(A), (C).

²¹⁶ *Perez v. Mortgage Bankers Ass'n*, 135 S. Ct. 1199, 1206, 1207 (2015).

²¹⁷ Justice Scalia's concurrence in *Mortgage Bankers* discussed the tension between the majority opinion and *Chevron*. *Mortgage Bankers*, 135 S. Ct. at 1211 (Scalia, J., concurring) ("Heedless of the original design of the APA, we have developed an elaborate law of deference to agencies' interpretations of statutes and regulations."). A commentator discussed the compatibility of the APA standard and *Chevron* when a court reviews an adjudication and said "any broad statement that a *Chevron*-type level of deference is generally applicable to agency adjudications seems difficult to reconcile with the APA." John F. Duffy, *Administrative Common Law in Judicial Review*, 77 *Tex. L. Rev.* 113, 191-207, 207 n.479 (1998). See also Caleb Nelson, *Statutory Interpretation* 706-07 & n.26 (2011).

²¹⁸ *Mead*, 533 U.S. at 229-30 & n.12 ("the overwhelming number of our cases applying *Chevron* deference have reviewed the fruits of notice-and-comment rulemaking or formal adjudication.") (citing cases); see also *City of Arlington*, 133 S. Ct. at 1874; *Ne-gusie v. Holder*, 129 S. Ct. 1159, 1163-64 (2009); *SEC v. Chenery Corp.*, 332 U.S. 194 (1947) (giving significant deference and discretion to the SEC when the Court reviewed an adjudication long before *Chevron*).

ways accepted agency legal conclusions of ambiguous statutes as binding. A good illustration is *INS v. Cardoza-Fonseca*,²¹⁹ where the author of *Chevron*, Justice Stevens, wrote a majority opinion holding that *Chevron* deference did not apply to an agency's interpretation of a pure question of statutory construction in an adjudication. In deportation proceedings against the respondent, the INS applied the same meaning to two separate legal standards enabling an alien to seek relief from deportation. The Court did not agree with that legal analysis and rejected an agency claim to *Chevron* deference, even though it admitted that one of the statutory legal tests had "some ambiguity": "The question whether Congress intended the two standards to be identical is a pure question of statutory construction for the courts to decide. Employing traditional tools of statutory construction, we have concluded that Congress did not intend the two standards to be identical."²²⁰ The Court said courts must respect the agency's application of the legal standards to particular facts in case-by-case adjudications but explained that "our task today is much narrower, and is well within the province of the Judiciary."²²¹

The Court took a different approach in *FCC v. Fox Television Stations, Inc.* but nonetheless did not grant *Chevron* deference. In *Fox*, the Court applied the arbitrary and capricious standard from Section 706(2)(A) to an agency adjudication of alleged violations of the indecency provisions in the communications laws. Taking its guide from a precedent decided before *Chevron*,²²² the Court said the agency must articulate a satisfactory explanation for its actions and spent most of the opinion assessing whether the agency adequately explained its decision. The Court explained that this was a "narrow" standard of review and that it should not substitute its judgment for the agency's.²²³ Perhaps the Court intended this approach to be a *Chevron* analysis, but it did not say so, and the opinions for the justices never mentioned *Chevron*. Moreover, application of the standards in Section 706(2)(A) is not the same as the second part of the *Chevron* test.²²⁴

²¹⁹ 480 U.S. 421 (1987).

²²⁰ Id. at 446, 448.

²²¹ Id. at 448. See Caleb Nelson, *Statutory Interpretation* 716-18 (2011) (discussing *Cardoza-Fonseca* and several related Supreme Court decisions). In two recent cases, Justice Thomas queried whether *Chevron* deference on questions of law raised separation of powers concerns; *Chevron* deference prevents a judge from exercising independent judgment on the law. See *Michigan v. EPA*, --- S. Ct. ---, --- (2015) (Thomas, J., concurring); *Mortgage Bankers*, 135 S. Ct. at 1213-1221 (Thomas, J., concurring in judgment).

²²² *Motor Vehicle Mfrs. Ass'n. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983).

²²³ *FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1810 (2009).

²²⁴ The relationship between *Chevron* and arbitrary or capricious review is the subject of considerable debate. See Gary Lawson, *Federal Administrative Law* 779-85 (6th ed. 2013); Caleb Nelson, *Statutory Interpretation* 712-13 (2011); Kenneth A. Bamberger & Peter L. Strauss, *Chevron's Two Steps*, 95 Va. L. Rev. 611, 621-25 (2009).

3. *Practice of the courts of appeals in reviewing legal conclusions in an SEC adjudication.*

The third reason a court would have not to give *Chevron* deference to the legal discussion in *Flannery* is that the actual practice of most courts of appeals is not to defer to the SEC on questions of law in an adjudication. In fact, several circuits explicitly apply a de novo standard of review to legal issues in an SEC adjudication.²²⁵ *Gebhart v. SEC*²²⁶ is an example. In *Gebhart*, the broker-dealer regulatory authority had found that the Gebharts, securities salespersons, committed securities fraud in violation of Rule 10b-5 by making false statements to clients in connection with the sale of promissory notes used to finance the conversion of mobile home parks to resident ownership. The SEC upheld the decision of the broker-dealer regulatory authority, and the Gebharts petitioned for review of the SEC decision. The Ninth Circuit vacated and remanded on the ground that the Commission had applied the wrong scienter standard.²²⁷ On remand, the SEC again determined that the Gebharts had acted with scienter. They again petitioned for review. The first question the court of appeals addressed was whether the SEC “applied the correct scienter requirement applicable to a claimed violation of section 10(b) and Rule 10b-5.” The court introduced its analysis by saying: “We review de novo the SEC’s conclusions of law” and the “Commission’s conclusions of law are to be set aside if arbitrary, capricious, or otherwise not in accordance with law.”²²⁸ This time, the appellate court agreed with the SEC.

The D.C. Circuit often hears petitions to review SEC adjudications, and its practice is not to apply *Chevron*. It applies the “arbitrary, capricious, ... or otherwise not in accordance with law” standard from section 706(2)(A) of the APA or otherwise reaches its own conclusions on matters of statutory interpretation. In *Rockies Fund, Inc. v. SEC*,²²⁹ the SEC had charged several respondents with violations of Rule 10b-5 in an administrative proceeding. The ALJ found violations, and the Commission affirmed. The respondents sought review in the D.C. Circuit. The court said

²²⁵ See *Erenstein v. SEC*, 316 Fed. Appx. 865 (11th Cir. 2008) (not for publication in Federal Reporter) (“We conduct a de novo review of the SEC’s legal conclusions.”); *Rooms v. SEC*, 444 F.3d 1208 (10th Cir. 2006) (“We review the SEC’s legal conclusions de novo.”); *Otto v. SEC*, 253 F.3d 960 (7th Cir. 2001) (This court may overturn an SEC sanctions order if it is unwarranted in law or without justification in fact.”). See also *Bob Evans Farms, Inc. v. NLRB*, 163 F.3d 1012, 1020 (7th Cir. 1998) (court declined to defer to an NLRB adjudication decision because the decision was not reasonable and did not withstand rational scrutiny); *Snyder v. Shalala*, 44 F.3d 896, 898 (10th Cir. 1995) (reversal is appropriate if the ALJ failed to apply the proper legal test in a Social Security case).

²²⁶ 595 F.3d 1034, 1040 & n.7 (9th Cir. 2010).

²²⁷ *Gebhart v. SEC*, 255 Fed. Appx. 254 (9th Cir. 2007) (unpublished decision).

²²⁸ *Gebhart*, 595 F.3d at 1040 & n.7 (quotation marks omitted).

²²⁹ 428 F.3d 1088 (D.C. Cir. 2005).

it may set aside the SEC's conclusions of law if "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" under section 706(2)(A) of the APA.²³⁰ The court reviewed the scienter standard the Commission applied and the evidence supporting the Commission's finding of scienter and concluded that substantial evidence did not support the Commission's finding.²³¹

In *Johnson v. SEC*,²³² the SEC had charged Johnson in an administrative proceeding for failing reasonably to supervise another broker-dealer employee. The Commission imposed a six-month suspension on Johnson, rejecting the argument that the relief was a penalty under the limitations provision in 28 U.S.C. § 2462. The D.C. Circuit disagreed and vacated the SEC's order, applying de novo review to the SEC's interpretation of section 2462: "Because § 2462 is a statute of general applicability rather than one whose primary administration has been delegated to the SEC, we interpret it de novo."²³³ That rationale avoided the question of deference, but it was not entirely accurate. The court was correct that part of the analysis was to determine the meaning of the word "penalty" in section 2462, but much of the analysis depended on whether suspension of a broker-dealer employee was remedial or a penalty. The nature of a suspension was a question answered by statutes within the administration of the SEC.

Two other courts of appeals have applied section 706(2)(A).²³⁴ One court applied a standard resembling the *Chevron* test.²³⁵

²³⁰ Id. at 1093.

²³¹ Id. at 1093-95.

²³² 87 F.3d 484 (D.C. Cir. 1996).

²³³ Id. at 486. See also *Pierce v. SEC*, 2015 WL 2445073 (D.C. Cir.). Pierce challenged an SEC decision in an enforcement case against him mainly on the ground that the case was barred by res judicata. The court said it would apply section 706(2)(A) to review the agency's legal conclusions, id. at *5, which in practice amounted to a de novo review. The court doubted whether one of the SEC's lines of analysis was consistent with the application of res judicata in the federal courts but then decided it did not need to resolve that question because an independent ground for the SEC decision was valid. Id. On that second ground, the appeals court did not defer to the agency's legal analysis. It engaged in its own, id. at *6-*8, and concluded that the SEC decision was "consistent with established law." Id. at *6.

²³⁴ *Kleinsler v. SEC*, 539 Fed. Appx. 7 (2d Cir. 2013) (summary order) ("When reviewing the SEC's conclusions of law, we apply the arbitrary and capricious standard set forth in the Administrative Procedure Act, which provides that a reviewing court shall 'hold unlawful and set aside agency action, findings, and conclusions found to be ... arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.' 5 U.S.C. § 706(2)(A)"); *Meadows v. SEC*, 119 F.3d 1219, 1224 (5th Cir. 1997) (applying section 706(2)(A) and stating: "legal conclusions are for the courts to resolve, although even in considering such issues the courts are to give some deference to the [agency's] informed judgment.") (internal quotation marks omitted).

4. *Effect of judicial decisions in the area.*

The fourth reason a court could decline to give *Chevron* deference to the legal discussion in *Flannery* rests on the active role the courts have been playing in defining the scope of liability under Section 17(a) and Rule 10b-5. A strong but not unfrayed strand in *Chevron* jurisprudence is that the courts do not defer when an agency interpretation varies from the way the courts, especially the Supreme Court, has been interpreting and applying the same legal provision.²³⁶ The precedents are not without inconsistencies, but judicial decisions are meant to have *stare decisis* effect on agencies.

For example, in *Negusie v. Holder*,²³⁷ the relevant agency had reached a legal conclusion in an adjudication based on a reading of an earlier Supreme Court decision. The court of appeals agreed with the agency, and the Supreme Court, in *Negusie*, conceded that the agency and the court of appeals had “some basis” for reaching their conclusions.²³⁸ It also admitted that the underlying statute was not explicit on the relevant issue.²³⁹ Nonetheless, the Supreme Court refused to accord *Chevron* deference to the agency’s view²⁴⁰ and disagreed with the agency’s and court of appeals’ reading of the earlier decision. The Court said that the earlier decision did not compel the conclusion the agency had reached²⁴¹ and that the agency had misapplied the precedent.²⁴² The Court therefore remanded the case for the agency’s views on the relevant statute unhindered by the mistaken belief that the Supreme Court’s precedent controlled the outcome.

Other cases reached similar conclusions. In one, the Court remarked: “Once we have determined a statute’s meaning, we adhere to our

²³⁵ See *Amanat v. SEC*, 269 Fed. Appx. 217 (3d Cir. 2008) (not for publication in Federal Reporter) (“With respect to legal conclusions, [t]he SEC’s interpretation of ambiguous text in the Exchange Act is entitled to deference if it is reasonable.”) (internal quotation marks omitted).

²³⁶ Gary Lawson, *Federal Administrative Law* 559 (6th ed. 2013) (“*Chevron* deference does not extend to agency interpretations of court opinions, even when the agency is entitled to deference in the interpretation of the statutes or regulations that were the subject of the court opinions.”).

²³⁷ 555 U.S. 511 (2009).

²³⁸ *Id.* at 518.

²³⁹ *Id.*

²⁴⁰ *Id.* at 516, 521.

²⁴¹ *Id.* at 519.

²⁴² *Id.* at 516.

ruling under the doctrine of stare decisis, and we assess an agency's later interpretation of the statute against that settled law."²⁴³

Based on *Negusie* and the similar authorities, the Supreme Court and lower court decisions discussed in Part II are relevant to whether the legal conclusions in *Flannery* deserve *Chevron* deference. The courts have been heavily involved in determining the scope of primary liability under Section 17(a) and Rule 10b-5, and a court considering the legal interpretations in *Flannery* would be justified in concluding that it is not bound if the court decides that the SEC had misapprehended the import of the judicial precedent.

5. *Potential criminal enforcement.*

A fifth reason is from a recent statement on a denial of certiorari, in which Justices Scalia and Thomas urged the courts to consider an issue that could result in denying *Chevron* deference to SEC interpretations of Section 17(a) and Rule 10b-5. In a case turning in part on the SEC's interpretation of section 10(b) in a notice-and-comment regulation, the Justices asked: "Does a court owe deference to an executive agency's interpretation of a law that contemplates both criminal and administrative enforcement?" The Justices raised a series of concerns about according *Chevron* deference to agency interpretations of such laws, which include Section 17(a) and Rule 10b-5.²⁴⁴ One stemmed from their view that only the Congress and not an agency has the power to define crimes. They also observed that deference would allow the executive to create new crimes within the boundaries of any ambiguities in a statute and would upend the rule

²⁴³ *Neal v. United States*, 516 U.S. 284, 295 (1996) (in an earlier case, Court determined one method for calculating a sentence for a drug violation; Sentencing Commission later adopted a different method; Court adhered to its earlier decision). See also *Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990) ("Once we have determined a statute's clear meaning, we adhere to that determination under the doctrine of stare decisis, and we judge an agency's later interpretation of the statute against our prior determination of the statute's meaning."); *Golden State Transit Corp. v. City of L.A.*, 493 U.S. 103, 112 (1989) ("A rule of law that is the product of judicial interpretation of a vague, ambiguous, or incomplete statutory provision is no less binding than a rule that is based on the plain meaning of a statute."); Richard J. Pierce, Jr., *Reconciling Chevron and Stare Decisis*, 85 *Geo. L.J.* 2225, 2226 (1997). But see *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 982-83 (2005) (in a rulemaking, Court said: "Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.").

²⁴⁴ Both Section 17(a) and Rule 10b-5 may be enforced in civil SEC enforcement cases, see 15 U.S.C. §§ 77h-1(a), 77t(b), 78u(d)(1), 78u-3(a), and in federal criminal prosecutions, see *id.* §§ 77t(b), 78u(d)(1).

that an ambiguity in a penal statute must be resolved in favor of the defendant.²⁴⁵

Those different lines of *Chevron* authority create significant questions about the obligation of a reviewing court to give controlling weight to the legal conclusions in *Flannery*. Several factors emerge from those authorities that apply to the *Flannery* enforcement adjudication and that weaken its claim to *Chevron* deference. We will discuss those in a moment, but, before we do, we must address whether the SEC's interpretation of an agency rule, Rule 10b-5, deserves special consideration.

D. **Court Deference to an Agency Rule.**

We must pause for a moment to consider one difference between Section 17(a) and Rule 10b-5 that might be important in selecting the appropriate standard of judicial review. Section 17(a) is a statute, and Rule 10b-5 is an SEC regulation. Does that difference affect the scope or depth of judicial review of SEC interpretations in an adjudication decision? The Supreme Court's approach to this question is shifting from near total deference to the agency to little deference.

The prevailing view for some time, called *Seminole Rock* or *Auer* deference, had been that an agency's construction of its own regulation has controlling weight unless it is plainly erroneous or inconsistent with the regulation.²⁴⁶ An agency's interpretation of its own regulation deserves *Chevron* deference. Under that view, the SEC's construction of the parts of Rule 10b-5 (but not Section 17(a)) would carry special weight.

Several recent Supreme Court decisions have begun to erode this strong deference to an agency's interpretation of its own regulation. In *Perez v. Mortgage Bankers Ass'n*,²⁴⁷ the Court considered the proper process for amending an agency interpretation of a regulation. In the course of the opinion, the majority noted that "*Auer* deference is not an inexorable command in all cases" and that, even "in cases where an agency's in-

²⁴⁵ *Whitman v. United States*, 135 S. Ct. 352 (2014) (Scalia, J., statement on denial of certiorari). The rule of lenity applies to a statute capable of both criminal and non-criminal enforcement. See *Leocal v. Ashcroft*, 543 U.S. 1, 11-12 n.8 (2004); *Carter v. Welles-Bowen Realty, Inc.*, 736 F.3d 722, 729 (6th Cir. 2013) (Sutton, J., concurring). But see *Babbitt v. Sweet Home Chapter of Communities for a Great Oregon*, 515 U.S. 687, 703-04 & n.18 (1995) ("We have never suggested that the rule of lenity should provide the standard for reviewing facial challenges to administrative regulations whenever the governing statute authorizes criminal enforcement.").

²⁴⁶ *Auer v. Robbins*, 519 U.S. 452, 461-63 (1997) (interpretation in an agency's amicus brief of an agency regulation); *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945). See also *Thomas Jefferson University v. Shalala*, 512 U.S. 504, 512 (1994); *Martin v. OSHA*, 499 US 144, 151 (1991) (agency has power to interpret its own regulations authoritatively).

²⁴⁷ 135 S. Ct. 1199 (2015).

terpretation receives *Auer* deference, ... it is the court that ultimately decides whether a given regulation means what the agency says.”²⁴⁸ The majority also said twice that an interpretive rule does not have the force and effect of law and is not accorded that weight in the adjudicatory process.²⁴⁹ With these two statements, the Court all but eliminated the need for a court to defer to an agency interpretation of a regulation in an adjudication. The agency interpretation has no legal weight and is ultimately dependent on judicial acceptance.²⁵⁰

Before *Mortgage Bankers*, the Court began to recognize various exceptions to *Auer* deference. *Christopher v. SmithKline Beecham Corp.* listed them and refused to apply *Auer* deference to an interpretation of an agency regulation in the agency’s amicus brief. The Court expressed particular concern with the potential for unfair surprise in an agency enforcement proceeding.²⁵¹

Other reasons exist for not according *Auer* deference to the SEC’s elaboration of Rule 10b-5. The agency does not have a leg up on the courts in understanding Rule 10b-5, as its manner of adoption demonstrates. In 1942, the SEC staff heard of a company president using misstatements to buy securities from shareholders. Section 17(a) could reach a seller but not a buyer, while section 10(b) of the Exchange Act authorized a rule that could reach fraud in the purchase or sale of a security. The staff and Commissioners hurried to draft and adopt Rule 10b-5 and did so in one day.²⁵² This was before the Administrative Procedure Act; the SEC did not

²⁴⁸ Id. at 1208 n.4.

²⁴⁹ Id. at 1204, 1208.

²⁵⁰ Three justices urged explicit reconsideration of *Auer* deference. Id. at 1210, 1211, 1213 (Alito, J., concurring in part and in the judgment; Scalia, J., concurring in the judgment; Thomas, J., concurring).

²⁵¹ 132 S. Ct. 2156, 2166-68 (2012) (“It is one thing to expect regulated parties to conform their conduct to an agency’s interpretations once the agency announces them; it is quite another to require regulated parties to divine the agency’s interpretations in advance or else be held liable when the agency announces its interpretations for the first time in an enforcement proceeding and demands deference.”). See Gary Lawson, *Federal Administrative Law* 551-53 (6th ed. 2013). See also *Rapoport v. SEC*, 682 F.3d 98 (D.C. Cir. 2012) (court applied arbitrary and capricious standard in section 706(2)(A) to review an SEC interpretation of an SEC Rule of Practice applied in an adjudication; court vacated and remanded because it found two flaws in the SEC’s decision).

²⁵² One morning in 1942, Milton Freeman, who was an Assistant Solicitor at the SEC, heard about possible misstatements by a company president buying securities and wrote a draft of Rule 10b-5 to cover misconduct by a buyer. Years later, he recalled: “I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where ‘in connection with the purchase or sale’ should be, and we decided it should be at the end.” Conference on Codification of the Federal Securities Laws, Remarks of Milton V. Freeman, 22 *Bus. Law.* 914, 922 (1967). Freeman and other members of the staff presented the draft to the Commissioners that morning or after lunch the same day, and the Commissioners unanimously approved the Rule. Id.; see also Milton V. Freeman, Foreword, 61 *Fordham L. Rev.* S1, S1-S2 (1993).

follow a notice-and-comment or other more formal process to adopt the Rule.²⁵³

In addition to the hasty drafting and adoption of the Rule, the language the Commissioners and staff chose did not derive from the agency's superior competence or experience. The language of Rule 10b-5 substantially mimics the statutory language of Section 17(a).²⁵⁴ It does little more than restate language that comes from Congress, and the near equivalence diminishes the rationale for *Auer* deference.²⁵⁵ The "existence of a parroting regulation does not change the fact that the question here is not the meaning of the regulation but the meaning of the statute. An agency does not acquire special authority to interpret its own words when, instead of using its expertise and experience to formulate a regulation, it has elected merely to paraphrase the statutory language."²⁵⁶ This is a further reason the SEC is not better placed to explain the regulatory text.

Another reason the Commission does not have special authority or competence to understand and interpret Rule 10b-5 is because, even apart from its Section 17(a) origins, Rule 10b-5 has become quasi-statutory. It has existed unchanged over 70 years and has been the subject of many judicial opinions. It has become woven into the fabric of the federal securities laws and is now part of the canon of those laws.

For these reasons, a reviewing court should not feel compelled to give controlling effect to the SEC's interpretations of Rule 10b-5 in *Flannery*. The court has grounds for not applying *Auer* deference.

E. ***Chevron* Deference and *Flannery*.**

This review of some of the *Chevron* jurisprudence suggests both that the Supreme Court and courts of appeals do not invariably apply *Chevron* deference to legal issues in an agency adjudication and that several particulars about *Flannery* would justify a reviewing court in not giving controlling weight to the interpretations of Rule 10b-5 and Section 17(a). The following paragraphs discuss those particular circumstances about *Flannery*. If a court agreed that *Chevron* did not apply, it could apply the standard of review in section 706(2), consider the persuasiveness

²⁵³ The SEC adopted Rule 10b-5 in 1942. 7 Fed. Reg. 3804 (May 22, 1942). The Administrative Procedure Act was enacted in 1946. Pub. L. 79-404, 60 Stat. 237.

²⁵⁴ See note 252 supra.

²⁵⁵ *Flannery* was mainly interpreting the statutory language of Section 17(a) either in Section 17(a) itself or in Rule 10b-5(a) and (c). The main difference between Section 17(a) and Rule 10b-5 is in the second subpart, and *Flannery* accepted the *Janus* decision as the construction of subpart (b) of Rule 10b-5. Consequently, when considering that main difference between Rule 10b-5(b) and Section 17(a)(2), the SEC was construing the statutory language of Section 17(a)(2) and not the language of the Rule. *Auer* deference does not apply to the Commission's views of Section 17(a)(2).

²⁵⁶ *Gonzales v. Oregon*, 546 U.S. 243, 257 (2006).

of the reasoning in *Flannery* along the lines of *Skidmore* and *Mead* deference, and review the legal conclusions the way an appellate court tests those of a lower court.

One factor militating against *Chevron* deference is that the Commission majority's determinations about the meaning and scope of the subparts of Rule 10b-5 and Section 17(a) are close to pure questions of law. Of course, depending on the situation, the difference between a question of law, fact, or policy can be elusive, but the discussion about the meaning of the parts of the main anti-fraud provisions in *Flannery* – nearly exclusively statutory language, as discussed above²⁵⁷ – was classic legal analysis using traditional tools of statutory and regulatory interpretation. *Flannery* concerned the “precise construction of statutory language” rather than “a determination of what policy best effectuates statutory objectives.”²⁵⁸ The Commission was not dealing with highly discretionary questions that implicated its expertise, such as the proper length of time for a suspension of an investment adviser or the factors showing that a broker-dealer failed to supervise in a reasonable manner. When an issue falls closer to the pure question of law end of the spectrum, the competence of the courts is at its highest, and the reasons for a court to bow to agency experience or expertise are weak.²⁵⁹ Section 706 of the APA on judicial review of agency action specifically reserves for the reviewing court “all relevant questions of law” and the interpretation of “statutory provisions.”

A second consideration is that the *Flannery* construction of Section 17(a) and Rule 10b-5 does not tap into the SEC's expertise in a material way. The two provisions are general anti-fraud rules with sub-provisions categorizing types of fraud or deception. These are legal concepts that have been within the province of the courts for centuries. The provisions have common-law terms and not technical terms of art for the securities markets. *Flannery* did not deal with statutes regulating areas well within the expertise and experience of the SEC on technical aspects of the operations of the securities markets, such as registered offerings of securities or regulation of the national market system. The essential legal question is how the words “employ,” “engage,” or “by means of” draw lines between primary and secondary liability and is not how to apply the legal standard to specific facts occurring in the securities markets.²⁶⁰ The agency does have years of experience with different varieties of situations involving de-

²⁵⁷ See text accompanying notes 254-55 supra.

²⁵⁸ *Negusie*, 555 U.S. at 528, 529 (Stevens, J., concurring in part and dissenting in part).

²⁵⁹ See *Negusie*, 555 U.S. at 528, 530 (Stevens, J., concurring in part and dissenting in part) (“The *Chevron* framework thus accounts for the different institutional competencies of agencies and courts: Courts are expert at statutory construction, while agencies are expert at statutory implementation.”).

²⁶⁰ See *Cardoza-Fonseca*, 480 U.S. at 448.

ceptive statements or conduct in the purchase or sale of securities, but so do the courts.

Another reason not to grant *Chevron* deference is that the courts have been actively addressing and resolving the legal issues in *Flannery* and should not be pre-empted by the SEC. A reviewing court could invoke the cases requiring an agency to treat court decisions as settled law,²⁶¹ but it would not need to go that far. It could apply a weak form of that doctrine. Here, many aspects of *Janus* and *Stoneridge* strongly indicate that the Supreme Court meant to resolve some of the issues in *Flannery*, but, even if that is not accepted, the SEC would be hard pressed to deny that the courts are robustly engaged in the field. A weaker form would be appropriate given that technical (but not persuasive) distinctions about *Janus* and *Stoneridge* exist and given that the courts of appeals have not yet reached consistent outcomes on the way to integrate *Janus* and *Stoneridge* into claims based on Section 17(a) and Rule 10b-5(a) and (c). Courts should take the Commission reasoning into account but reach independent conclusions, continue the debate, and allow the process of review through the courts of appeals to the Supreme Court to work as normal. The genius of the federal judicial system will reach considered and informed final conclusions about the scope of primary liability under the anti-fraud provisions. The courts should not let the Commissioners' claim to *Chevron* dominance cut this debate or process short. Recall that the Court in *Janus* turned aside a government assertion for deference to the SEC's interpretation, noting the Court's repeated disagreement with the SEC's broad positions on Rule 10b-5.²⁶²

Another reason that should give a court pause about treating *Flannery* with *Chevron* deference is that the decision, as an adjudication about specific conduct of two defendants charged with violations of law, did not receive public comment. The only submissions from members of the public that the Commissioners had were the briefs of the defendants, and those might not have ranged as widely as the *Flannery* opinion did. Commentators questioned whether the defendants had adequate notice of and opportunity to brief all the issues *Flannery* ultimately addressed.²⁶³ The Commissioners had no public comment or contribution about the legal interpretations they planned to adopt. As a result, *Flannery* might not qualify as "the agency's fair and considered judgment on the matter."²⁶⁴

²⁶¹ See text and accompanying note 243 supra.

²⁶² *Janus*, 131 S. Ct. at 2303 n.8; see text and accompanying notes 104-06 supra.

²⁶³ Matthew Martens et al., supra note 12, at 2 ("Most of the Commission's interpretations have no relation to the case at hand (indeed, many of the legal issues were never even briefed by the parties)").

²⁶⁴ *Auer*, 519 U.S. at 462.

A final reason is that the interpretations in *Flannery* were tantamount to agency litigating positions and therefore could fairly be discounted. They were constructions of the provisions the Commission had voted to charge as violations in the document commencing the case against Flannery and Hopkins. After the ALJ found no violations, the Commission relied on its new conclusions to hold Flannery and Hopkins liable, creating an unfortunate appearance that the Commissioners rigged the outcome to win the case and vindicate its initial charges. The Commission had a similar and more general incentive to find broad meanings to boost its enforcement program. The *Flannery* legal conclusions were expansive and detailed constructions of the anti-fraud provisions the SEC commonly asserts in enforcement cases. As litigating positions, *Flannery* should not receive deference.²⁶⁵

The better course for a reviewing court would be to apply Section 706(2), assess the legal discussion in *Flannery* as it would a lower court decision, and accept interpretations that are in accordance with the law as the reviewing court sees it. A court should reach an independent judgment de novo on the meaning of laws applied by the SEC in an adjudication. It should accept factual conclusions supported by substantial evidence, as both the Exchange Act and Section 706(2)(E) provide.

This approach parallels the standards an appellate court applies when reviewing a lower tribunal decision. As commentators have suggested, courts frequently apply an appellate review approach to adjudications by administrative agencies. “Modern administrative law is built on the appellate review model of the relationship between reviewing courts and agencies.”²⁶⁶ The reviewing court is presumed to have superior competence to resolve questions of law and should review questions of law de novo but should recognize a zone of discretion for matters within the special expertise of the agency, such as resolving questions of fact.²⁶⁷

A reviewing court should treat the SEC adjudication as a trial court judgment. The agency’s views on the law should be taken into account and might be insightful and persuasive, but the final decision is for a court not the SEC.

²⁶⁵ See *Smiley v. Citibank*, 517 US 735, 740-1 (1996) (we deny deference “to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice”); Bradley George Hubbard, Comment, Deference to Agency Statutory Interpretations First Advanced in Litigation? The *Chevron* Two-Step and the *Skidmore* Shuffle, 80 U. Chi. L. Rev. 447 (2013).

²⁶⁶ Thomas W. Merrill, Article III, Agency Adjudication, and the Origins of the Appellate Review Model of Administrative Law, 111 Colum. L. Rev. 939, 940 (2011).

²⁶⁷ *Id.* at 940, 999; Edward Rubin, It’s Time to Make the Administrative Procedure Act Administrative, 89 Cornell L. Rev. 95, 142 (2003) (arguing that APA concentrates on a judicial concept of governance).

CONCLUSION

The upshot of the *Flannery* opinion by a bare majority of SEC Commissioners in an enforcement adjudication is that it creates both substantive and procedural concerns. The substantive concern is that the Commission defined primary liability under portions of the major anti-fraud provisions in expansive ways that disregarded the reasoning and rationale of the Supreme Court and some courts of appeals. The Supreme Court has sought to clarify the distinction between primary and secondary liability under Rule 10b-5, yet the Commission's *Flannery* decision all but eradicated the distinction and committed the same error with Section 17(a). It regained the ground on primary liability that was lost in *Stoneridge* and *Janus* and then went further with novel constructions of primary liability based on lawful, non-deceptive actions or exorbitant doctrines of but-for causality.

That flouting of the Supreme Court's guidance also created one of the procedural concerns. The SEC, as an administrative agency, superseded judicial decisions by re-interpreting and extending the prohibitions in Rule 10b-5 and Section 17(a). This upsets traditional expectations about the role of the courts in the development of the law.

A second procedural concern was the SEC's determination that its interpretations of law in an enforcement adjudication were controlling on the courts under *Chevron*. The precedents identify good reasons for not granting *Chevron* deference to *Flannery*, but the larger worry is divorcing agency lawmaking in its own enforcement cases from judicial review and oversight. The aggregation of an agency's decision to roll back Supreme Court precedent and to consolidate for itself ultimate decision-making power over questions of law traditionally left to the courts would seriously alter a balance between agencies and courts long recognized in our system of government.