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# ARTICLES

## WHITE COLLAR CRIME'S GRAY AREA: THE ANOMALY OF CRIMINALIZING CONDUCT NOT CIVILLY ACTIONABLE

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ABSTRACT

Substantive and procedural differences between criminal and civil treatment of conduct sounding in securities fraud combine to cause the following anomaly: certain false statements to investors may be actionable criminally—subjecting individual defendants to imprisonment—but not civilly—leaving victims without remedy. The imposition of criminal punishment for conduct that does not invoke civil liability risks disrupting the current scheme of securities regulation, at the expense of considerations deemed important by Congress and the courts. Moreover, the extension of criminal liability beyond the scope of civil liability debunks the assumption, which underlies the current scholarship on the civil-criminal divide, that criminal liability is a subset of civil liability in circumstances where the relevant conduct injures identifiable individuals. This article demonstrates that criminal liability is more expansive than civil liability in the context of securities fraud, analyzes the impact of this anomaly on the current scheme of securities regulation, and considers whether the rationales underlying the leading theories of the civil-criminal divide explain this unique liability configuration. This article concludes that,

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although this configuration has destabilizing effects, it is arguably consistent with many of the theories underlying the civil-criminal divide. Therefore, this article proposes a two-step solution to further the rationales of the civil-criminal divide while preserving the delicate balance of the current scheme of securities regulation.

## I. INTRODUCTION

Substantive and procedural differences between criminal and civil treatment of conduct sounding in securities fraud combine to cause the following anomaly: certain false statements to investors may be actionable criminally—subjecting individual defendants to imprisonment—but not civilly—leaving victims without remedy. This article examines five of these differences, demonstrates how they combine to cause this anomalous civil and criminal treatment of conduct sounding in securities fraud, analyzes the impact of this anomaly on the current scheme of securities regulation, and considers whether the rationales underlying the leading theories of the civil-criminal divide explain the anomaly.

Part II of this article demonstrates that discrepancies between criminal and civil liability for securities fraud result in the criminalization of conduct not civilly actionable. First, the elements of the federal crime are often broader than the elements of the civil cause of action. In federal criminal prosecutions for conduct sounding in securities fraud, a lower materiality standard often applies than in civil cases, forward-looking statements are not protected by the "safe harbor" that is often invoked in civil cases, and liability is not confined to primary violators as in private civil actions. Moreover, at the state level, broad blue-sky laws and federal preemption of state civil securities class actions combine to criminalize conduct that is not civilly actionable. Finally, courts do not subject criminal indictments to the same level of pretrial scrutiny as civil complaints, and motions to dismiss are less favored in criminal cases than in civil cases.

Part III of this article shows that the imposition of criminal punishment for conduct not civilly actionable risks disrupting the current scheme of securities regulation, at the expense of considerations deemed important by Congress and the courts. The lower materiality standard and the unavailability of the safe harbor in criminal cases may chill corporate disclosure and may affect what information reasonable investors rely upon when making investment decisions. In addition, the potential of criminal aiding and abetting liability may discourage secondary actors from advising less established companies. Further, the broader criminal statutes may shift enforcement responsibility away from the Securities and Exchange Commission ("SEC") to the Department of Justice and to the states. Moreover, the criminalization of wide swathes of corporate conduct affords prosecutors broad discretion to decide whom to prosecute, invoking concerns about selective prosecution and separation of powers, and affords the SEC remarkable leverage in negotiating civil settlements. Finally, the narrow scope of private civil liability leaves injured investors without remedy.

Part IV of this article examines whether any of the dominant theories about the civil-criminal divide explains the anomalous relationship between civil and criminal liability in the context of securities fraud. The extension of criminal liability beyond the scope of civil liability debunks the assumption underlying the current scholarship on the civil-criminal divide that criminal liability is a subset of civil liability, but an examination of the rationales behind the leading theories of the civil-criminal divide lends some support for this unique configuration of liability in the context of securities fraud.

Finally, Part V of this article proposes a two-step solution. First, in light of the wide-ranging consequences of imposing criminal liability for conduct that does not incur civil securities fraud liability, Congress should reign in the scope of criminal liability to the current reach of private civil liability for conduct sounding in securities fraud. Second, because the more expansive reach of criminal liability is arguably consistent with many of the theories underlying the civil-criminal divide, Congress should consider carefully whether to expand the reach of criminal liability—while recognizing and compensating for the impacts of that expansion on the carefully balanced scheme of securities regulation.

## II. CONDUCT THAT IS NOT ACTIONABLE AS CIVIL SECURITIES FRAUD MAY BE CRIMINALLY PROSECUTED.

Five major differences between criminal and civil treatment of conduct sounding in securities fraud create an anomaly in which conduct not actionable as securities fraud may nonetheless be criminally prosecuted. First, prosecutors may use the criminal wire and mail fraud statutes, which have no civil equivalent, to prosecute conduct that does not violate the securities fraud statute ("the wire/mail fraud run-around"). Second, an individual defendant may be held criminally, but not civilly, liable for allegedly false forward-looking statements accompanied by meaningful cautionary language. Third, an individual defendant may be criminally prosecuted for aiding and abetting securities fraud, but an investor injured by the defendant's conduct is barred from asserting a private right of action. Fourth, some state blue-sky laws impose criminal liability for conduct that is not civilly actionable as securities fraud. Fifth, courts do not subject criminal indictments for securities fraud to the same degree of pretrial scrutiny as civil securities fraud complaints, leaving more issues to the jury. As shown below, these differences allow conduct that is not actionable as civil securities fraud to nonetheless be criminally prosecuted.

### *A. Differing Materiality Standards for Wire and Mail Fraud and for Securities Fraud Create the "Wire/Mail Fraud Run-Around."*

Conduct cognizable as securities fraud is often within the scope of the wire and mail fraud statutes. Securities fraud liability, both civil and criminal, is premised on (1) a false or misleading statement or omission (2) that is material and (3) made with scienter.[1] Wire and mail fraud require the following elements: (1) "existence of a scheme to defraud"; (2) "using or causing the use of the mail [or wires] to execute the scheme"; and (3) "specific intent to defraud."[2] Virtually every statement that could form the basis of a securities fraud claim (*e.g.*, a statement in an analyst call, in a webcast, in a press release, or in a Securities and Exchange Commission filing) is disseminated via the wires or mail, thus satisfying the jurisdictional requirement for mail or wire fraud.[3] For example, prosecutors have charged defendants with wire fraud for allegedly making false statements in forms filed electronically

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[1] 15 U.S.C. § 78j(b) (2006); Stoneridge Inv. Partners, L.L.C v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 768 (2008). Civil securities fraud also requires reliance by the plaintiff on the defendant's statement or omission and resulting damages to the plaintiff. *Id.*

[2] 18 U.S.C.A. §§ 1341, 1343 (West 2000 & Supp. 2008); United States v. Lucas, 516 F.3d 316, 339 (5th Cir. 2008); United States v. Welch, 327 F.3d 1081, 1104 (10th Cir. 2003); United States v. Sayakhom, 186 F.3d 928, 941 (9th Cir. 1999).

[3] *See* NATIONAL INVESTOR RELATIONS INSTITUTE, STANDARDS OF PRACTICE FOR INVESTOR RELATIONS 30 (3d ed. 2004) ("There are many different ways to reach investors and the public; some of the most obvious technologies include the major wire services, conference calls, broadcast fax and fax-on-demand services, e-mail, video conferences, Web sites and electronic EDGAR filings.").

with the SEC,[4] in press releases distributed via the wires,[5] and in analyst and investor conference calls.[6] In other words, if a prosecutor determines that an individual defendant made an allegedly false statement to investors, the prosecutor may often choose whether to charge securities fraud, wire fraud, mail fraud, or some combination thereof.

If the same statements were actionable as securities fraud, wire fraud, and mail fraud, a prosecutor's decision to prosecute the conduct as wire or mail fraud would have little practical consequence, other than perhaps an increased incentive for the defendant to accept a plea deal. Since each use of the mail or wires can be separately charged, prosecutors have tremendous leverage in convincing defendants to plead guilty to just one count of mail or wire fraud—rather than face trial on numerous counts.[7]

The same statements are not, however, actionable as securities fraud and as wire or mail fraud. The materiality standard for wire and mail fraud is lower than for securities fraud, opening the door of criminal prosecution to more statements.[8]

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[4] *E.g.*, Criminal Information at 2, United States v. Hurley, No. 1-04-cr-00123-PB (D.N.H. May 18, 2004); Information at 10, United States v. Ayers, No. 2:03-cr-00183 (N.D. Ala. April 3, 2003); Indictment at 17, United States v. Wittig, No. 5:03-cr-40142-JAR (D. Kan. Dec. 3, 2003); Indictment at 16, United States v. Grabske, No. 3:01-cr-00324-CRB (N.D. Cal. Aug. 30, 2001). These charging documents are available on the website of the Department of Justice's ("DOJ") Corporate Fraud Task Force, at http://www.usdoj.gov/dag/cftf/.

[5] *E.g.*, Indictment at 21–23, United States v. Scrushy, No. 2:03-cr-00530-KOB-TMP (N.D. Ala. Oct. 29, 2003); Indictment at 5, United States v. Lash, No. 3:02-cr-00366-H (S.D. Cal. Feb. 12, 2002); Indictment at 48–50, United States v. Polishan, No. 3:CR-96-274 (M.D. Pa. Oct. 29, 1996). These charging documents are available on the website of the DOJ's Corporate Fraud Task Force, at http://www.usdoj.gov/dag/cftf/.

[6] *E.g.*, Indictment at 21–22, United States v. Scrushy, No. 2:03-cr-00530-KOB-TMP (N.D. Ala. Oct. 29, 2003); Indictment at 5, United States v. Lash, No. 3:02-cr-00366-H (S.D. Cal. Feb. 12, 2002); Information at 13, United States v. Giesecke, No. 2:02-cr-01028-PA (C.D. Cal. Sept. 25, 2002). These charging documents are available on the website of the DOJ's Corporate Fraud Task Force, at http://www.usdoj.gov/dag/cftf/.

[7] Jennifer S. Recine, Note, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535, 1552 (2002) ("[A] prosecutor might use the fact that the defendant could be charged with five hundred counts of mail fraud to secure a plea on one count of mail fraud.").

[8] Similarly, 18 U.S.C.A. § 1001 (West 2000 & Supp. 2008), which imposes liability for making false statements in a matter within the jurisdiction of the federal government, affords a run-around for allegedly false statements contained in SEC filings because the materiality standard under § 1001 is identical to the standard under the wire and mail fraud statutes. *See* United States v. Gaudin, 515 U.S. 506, 509 (1995) (defining the materiality standard under § 1001); United States v. Bilzerian, 926 F.2d 1285, 1301 (2d Cir. 1991) (affirming the use of § 1001 to prosecute false statements in SEC filings).

1. The Materiality Standard for Wire and Mail Fraud Is Lower than for Securities Fraud.

Materiality is an essential element of securities fraud and of wire and mail fraud, but materiality is defined differently in the two contexts. The materiality bar to securities fraud liability is higher than the materiality bar to wire and mail fraud liability.

In the securities fraud context, materiality is an objective standard.[9] A statement is material if "'there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.'"[10] In other words, "[i]t is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant."[11] This standard depends on "the significance of an omitted or misrepresented fact to a reasonable investor."[12] When applying this objective materiality standard, courts routinely dismiss securities fraud claims based on vague forward-looking statements and vague characterizations of present fact.[13] For example, courts have held that the following statements are immaterial as a matter of law:

"Advanta's credit quality continues to be among the best in the industry."[14]

"Our emphasis on gold cards—and targeting of high quality customer prospects with great potential for profitability—sets us apart from other credit card issuers."[15]

"Our superior cost structure for delivering and servicing financial products allows us to achieve outstanding returns with highly competitive pricing and flexibility."[16]

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[9] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 445 (1976) ("The question of materiality, it is universally agreed, is an objective one . . . .").

[10] Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) (quoting *TSC Indus.*, 426 U.S. at 449).

[11] *Id.* at 238.

[12] *TSC Indus.*, 426 U.S. at 445.

[13] Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1718–20 (1998) (identifying the types of statements that courts frequently dismiss as immaterial); *see, e.g.*, City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 671 (6th Cir. 2005) ("[S]tatements describing a product in terms of 'quality' or 'best' or benefiting from 'aggressive marketing' are too squishy, too untethered to anything measurable, to communicate anything that a reasonable person would deem important to a securities investment decision."); Southland Sec. Corp. v. Inspire Ins. Solutions, Inc., 365 F.3d 353, 372 (5th Cir. 2004) ("The generalized, positive statements about the company's competitive strengths, experienced management, and future prospects are not actionable because they are immaterial.").

[14] *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 537–39 (3d Cir. 1999).

[15] *Id.*

[16] *Id.*

"We believe that Food Lion's Extra Low Prices and its clean and conveniently located stores are especially well suited to the demands of our customers."[17]

The company "was 'optimistic' about its earnings and 'expected' Marlboro to perform well."[18]

The immateriality of allegedly fraudulent statements is one of the most heavily litigated—and most frequently successful—issues in securities fraud litigation.[19] In a recent study, David A. Hoffman analyzed 472 securities fraud opinions and found that 385 of them addressed materiality.[20] Of those addressing materiality, forty-four percent dismissed at least one claim as immaterial as a matter of law.[21]

In the wire and mail fraud context, on the other hand, materiality is a subjective standard. In the landmark Supreme Court case imposing a materiality requirement in wire and mail fraud cases, *Neder v. United States*, the Court cited with approval two definitions of materiality.[22] The first definition, previously articulated in *United States v. Gaudin*[23] and subsequently adopted by most courts for use in wire and mail fraud cases,[24] states: "[A] false statement is material if it has 'a natural tendency to influence, or [is] capable of influencing, the decision of the decisionmaking body to which it was addressed.'"[25] The second definition is derived from the *Restatement (Second) of Torts*, which instructs that

> a matter is material if: '(a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question;' or '(b) the maker of the representation knows or has reason to know

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17 Longman v. Food Lion, Inc., 197 F.3d 675, 685 (4th Cir. 1999).

18 San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 811 (2d Cir. 1996).

19 *See* O'Hare, *supra* note 13, at 1697 (recognizing that "the puffery defense is alive and well").

20 David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 563 (2006).

21 *Id.* at 564; *see also* Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 116 n.94 (2002) (surveying motions to dismiss and finding that over 70 percent of the surveyed motions involved materiality determinations in favor of the defendants).

22 Neder v. United States, 527 U.S. 1, 25 (1999) (holding that "materiality of falsehood is an element of the federal mail fraud, wire fraud, and bank fraud statutes").

23 United States v. Gaudin, 515 U.S. 506, 509 (1995).

24 *E.g.*, United States v. Lucas, 516 F.3d 316, 339 (5th Cir. 2008); United States v. McAuliffe, 490 F.3d 526, 531 (6th Cir. 2007).

25 *Neder*, 527 U.S. at 16 (quoting *Gaudin*, 515 U.S. at 509).

> that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it.'[26]

Both definitions of materiality cited in *Neder* include within their reach statements that an objectively reasonable person would not regard as important. The *Gaudin* definition includes statements that, although not having a "natural tendency to influence," are nonetheless "capable of influencing" the decision. Similarly, part (b) of the Restatement definition explicitly extends to statements that a reasonable person would not regard as important in determining his choice of action. Consistent with these definitions, the Ninth Circuit has rejected the argument that an objective materiality standard should be applied in wire and mail fraud cases.[27] In addition, the Eleventh Circuit has noted that the materiality threshold for wire and mail fraud is akin to a "minimal relevance" standard.[28]

The subjective materiality standard used in wire and mail fraud cases is also consistent with the companion doctrine, adopted by a majority of the circuits, that a victim's gullibility is irrelevant to liability for wire or mail fraud.[29] A few circuits have, without connecting their pronouncements to the materiality standard, stated that a fraudulent scheme must be credible enough to influence a reasonable person in order to be actionable as wire or mail fraud.[30] The trend, however, is away from this minority rule

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[26] *Id.* at 22 n.5 (quoting RESTATEMENT (SECOND) OF TORTS § 538 (1977)).

[27] United States v. Tarallo, 380 F.3d 1174, 1190–91 (9th Cir. 2004) (rejecting the defendant's argument that the mail fraud materiality instruction should require that "for a statement to be material, it must be 'important' to a reasonable person" and reaffirming that "[t]he laws against fraud are designed to protect the naive and careless as well as the experienced and careful").

[28] Fla. State Conference of the NAACP v. Browning, 522 F.3d 1153, 1173–74 (11th Cir. 2008) (noting that "in the federal criminal mail and wire fraud context, materiality seems to take on a much lower evidentiary threshold").

[29] *See* United States v. Thomas, 377 F.3d 232, 243 (2d Cir. 2004) (holding that a victim's gullibility is irrelevant); United States v. Maxwell, 920 F.2d 1028, 1036 (D.C. Cir. 1990) ("Appellant is simply wrong, however, if she means to assert that the wire fraud statute does not apply where the persons defrauded unreasonably believed the misrepresentations made to them."); United States v. Brien, 617 F.2d 299, 311 (1st Cir. 1980) (holding that, when enacting the mail fraud statute, there was "no intention on the part of Congress to differentiate between schemes that will ensnare the ordinary prudent investor and those that attract only those with lesser mental acuity"); U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL, CRIMINAL RESOURCE MANUAL § 9-43.100 (1997), *available at* www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/title9.htm [hereinafter CRIMINAL RESOURCE MANUAL] (instructing that mail or wire fraud liability is not affected by the gullibility of the victims).

[30] *See* United States v. Jamieson, 427 F.3d 394, 416 (6th Cir. 2005) (holding that a mail

and toward using the credibility of the scheme merely as an indicator of whether the defendant possessed the requisite intent to defraud.[31]

2. Prosecutors Are Using the Wire/Mail Fraud Run-Around.

Prosecutors may evade the objective materiality standard required under securities fraud jurisprudence by charging wire or mail fraud rather than securities fraud. The data shows that prosecutors are indeed as eager to charge conduct sounding in securities fraud as wire or mail fraud.

The criminal cases chosen by the Department of Justice's ("DOJ") Corporate Fraud Task Force as "Significant Criminal Cases and Charging Documents" provide a telling snapshot of how prosecutors are using the wire and mail fraud statutes. Of the seventy-nine cases sounding in securities fraud on this list, prosecutors charged wire or mail fraud in forty-nine cases, or sixty-two percent.[32] Moreover, in forty-nine percent of the cases charging mail or wire fraud for conduct sounding in securities fraud, prosecutors did not even charge securities fraud.[33]

Prosecutors' heavy reliance on wire and mail fraud is further evidenced by the overall charging statistics. According to the data compiled by the Federal Justice Statistics Resource Center for the

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fraud scheme must "be credible enough to 'deceive persons of ordinary prudence and comprehension'"); United States v. Gray, 367 F.3d 1263, 1268, 1271 (11th Cir. 2004) (affirming, paradoxically, both the use of the *Gaudin* definition of materiality in a mail fraud case and holding that the misrepresentation must be one that "'a reasonable person would have acted on'" (quoting United States v. Brown, 79 F.3d 1550, 1557 (11th Cir. 1996))).

[31] *Thomas*, 377 F.3d at 243 (explaining that the ordinary prudence standard is meant to be helpful in gauging a defendant's intent and "is not a shield which a defendant may use to avoid a conviction for a deliberately fraudulent scheme"); *see also* Mark Zingale, Note, *Fashioning a Victim Standard in Mail and Wire Fraud: Ordinarily Prudent Person or Monumentally Credulous Gull?*, 99 COLUM. L. REV. 795, 827 (1999) (proposing to resolve the circuit split by using the subjective standard in order to focus on the defendant's intent).

[32] U.S. Dep't of Justice, Corporate Fraud Task Force, Significant Criminal Cases and Charging Documents, http://www.usdoj.gov/dag/cftf/cases.htm (last visited Nov. 21, 2008). This data was compiled from a set of seventy-nine charging documents which were selected using the following criteria: First, all documents charging securities fraud for a false misrepresentation or omission, as opposed to insider trading, were included in the set. Second, all documents charging wire or mail fraud and sounding in securities fraud were included in the set. Third, for purposes of this set, documents charging only conspiracy to commit securities, mail, or wire fraud—but not charging an underlying offense of securities, mail, or wire fraud—were excluded. Fourth, documents naming a corporate defendant, rather than an individual defendant, were excluded from the set. A chart of the seventy-nine documents included in the set, as well as a list of all charging documents listed on the website, is on file with the author and is available for review upon request.

[33] *Id.*

years 1999 through 2006, the number of defendants charged with securities fraud is dwarfed by the number charged with mail or wire fraud. On average during this time period, 119 defendants were charged with securities fraud each year.[34] During this same period, an average of 720 defendants were charged with mail fraud per year, and an average of 404 defendants were charged with wire fraud per year.[35] In other words, on average, almost ten times as many defendants were charged with mail or wire fraud as with securities fraud. Even taking into account that many wire and mail fraud cases do not sound in securities fraud, the disparity is staggering.

Prosecutors' predilection for using the wire and mail fraud statutes to prosecute white collar crime has not gone unnoticed. Congress recognized, and approved of, the use of mail and wire fraud to prosecute corporate executives' wrongdoing when it passed the White Collar Crime Penalty Enhancement Act of 2002 (the "WCCPA") as part of the Sarbanes-Oxley Act. The WCCPA increased the maximum sentences for mail and wire fraud from five years to twenty years.[36] By including these enhancements in the Sarbanes-Oxley Act, which was intended to address corporate fraud,[37] Congress implicitly approved the use of the mail and wire fraud statutes to prosecute corporate executives. Moreover, on the Senate floor, Senators Trent Lott,[38] Joe Biden,[39] and Orrin Hatch[40]

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[34] *See* Federal Justice Statistics Resource Center, http://fjsrc.urban.org (last visited Nov. 21, 2008). The data can be selected for the following variables: (1) statistic (here, "number of defendants in cases filed"); (2) year (here, 1999 through 2006); and (3) type of charge (here, 15 U.S.C. § 78j (2000) and 18 U.S.C.A. § 1348 (West Supp. 2008)).

[35] *See* Federal Justice Statistics Resource Center, http://fjsrc.urban.org (last visited Nov. 21, 2008). The data can be selected for the following variables: (1) statistic (here, "number of defendants in cases filed"); (2) year (here, 1999 through 2006); and (3) type of charge (here, 18 U.S.C.A. §§ 1341, 1343 (West 2000 & Supp. 2008)).

[36] 18 U.S.C.A. §§ 1341, 1343 (West 2000 & Supp. 2008); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 903, 116 Stat. 745, 798 (2002).

[37] H.R. REP. NO. 107-610, at 69 (2002) (Conf. Rep.) (explaining that one of the purposes of the Sarbanes-Oxley Act is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws").

[38] 148 Cong. Rec. S6545 (daily ed. July 10, 2002) (statement of Sen. Lott) ("Mail fraud and wire fraud statutes are often used in criminal cases involving corporate wrongdoing. So obviously this is an area that is of concern and needs to be addressed.").

[39] 148 Cong. Rec. S6549 (daily ed. July 10, 2002) (statement of Sen. Biden) ("When these penalty enhancements are taken in combination with the new 10-year felony for securities fraud contained in the amendment I have co-sponsored with Senator Leahy, the Government will have the full range of prosecutorial arrows in its quiver to fight pension crooks and corporate wrong doers.").

[40] 148 Cong. Rec. S6550 (daily ed. July 10, 2002) (Statement of Sen. Hatch) ("Because prosecutors frequently use the mail and wire statutes to charge acts of corporate misconduct,

explicitly voiced their approval of this use of the mail and wire fraud statutes. In addition, numerous commentators have recognized that prosecutors rely heavily on wire and mail fraud to prosecute white collar crime.[41] In fact, the DOJ has explicitly encouraged its prosecutors to consider the mail and wire fraud statutes as "important tools" to address fraud within the scope of other criminal statutes.[42]

3. The Wire/Mail Fraud Run-Around Results in the Criminalization of Conduct That Is Not Civilly Actionable.

The wire/mail fraud run-around permits defendants to be held criminally liable for conduct that does not violate the securities fraud statutes. Unlike the securities fraud statutes, the wire and mail fraud statutes do not have companion civil causes of action.[43] As a consequence, civil plaintiffs may not use the wire/mail fraud run-around, resulting in the criminalization of conduct not civilly actionable.

This anomaly has gone unremarked. Although courts have rejected the argument that a more general criminal statute, like the mail and wire fraud statutes, should not be used to prosecute conduct that is more narrowly addressed in another criminal statute,[44] courts have not specifically addressed whether it is

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it is important that we ensure that the penalties that apply to such offenses are sufficiently severe to deter and punish corporate wrongdoers.").

[41] Luke Alverson, *Sarbanes-Oxley §§ 302 & 906: Corporate Reform or Legislative Redundancy? A Critical Look at the "New" Corporate Responsibility for Financial Reports*, 33 SEC. REG. L.J. 15, 27 (2005) (recognizing that mail fraud "has a history of being used in prosecuting securities violations arising from filings containing false information"); Peter R. Ezersky, Note, *Intra-Corporate Mail and Wire Fraud: Criminal Liability For Fiduciary Breach*, 94 YALE L.J. 1427, 1441–42 & n.63 (1985) (suggesting that the "open-ended elements" of mail and wire fraud allow prosecutors to establish criminal liability "on the cheap"); Jed S. Rakoff, *The Federal Mail Fraud Statute (Part I)*, 18 DUQ. L. REV. 771, 771 (1980) (from the perspective of a former federal prosecutor of white collar crime, describing the mail fraud statute as "our Stradivarius, our Colt 45, our Louisville Slugger, our Cuisinart—and our true love").

[42] *See* CRIMINAL RESOURCE MANUAL, *supra* note 29, § 955 ("The mail fraud and wire fraud statutes are becoming important tools in prosecutions of a) RICO violations, b) money laundering, c) financial institution fraud, and d) telemarketing fraud. Mail and wire fraud violations that support prosecutions in these areas can result in more severe sanctions and can form the basis for civil or criminal forfeiture.").

[43] 18 U.S.C.A. §§ 1341, 1343 (West 2000 & Supp. 2008).

[44] For example, in *United States v. Bilzerian*, a split panel of the Second Circuit affirmed the use of 18 U.S.C. § 1001 to prosecute conduct within the scope of the antifraud provisions of the securities statutes, despite the Second Circuit's then-applicable (and now overruled) decisions that materiality was not an element of § 1001. 926 F.2d 1285, 1300 (2d Cir. 1991) ("It is settled law that 'when an act violates more than one criminal statute, the Government

appropriate to use a general criminal statute to criminalize conduct that is not even civilly actionable. Moreover, those decrying the expansive interpretation of the mail and wire fraud statutes have not objected that it criminalizes conduct that is not even civilly actionable.[45] Even the Supreme Court appears to have overlooked this bizarre ramification of the breadth of the wire and mail fraud statutes. In *United States v. O'Hagan*, the majority mused that "practical consequences for individual defendants might not be large" if misappropriation conduct were classified as mail fraud but not securities fraud.[46] This rumination failed to recognize the impact on individual defendants' exposure to civil liability. If the conduct were classified as securities fraud, the defendants would be subject to civil liability for insider trading to contemporaneous traders.[47] If the conduct in *O'Hagan* was classified as mail fraud but not securities fraud, no private right of action would exist.[48]

### *B. A "Safe Harbor" Shields Forward-Looking Statements from Civil, but Not Criminal, Liability.*

A second substantive reason for the anomalous civil and criminal treatment of conduct sounding in securities fraud is the Private Securities Litigation Reform Act's ("PSLRA") "safe harbor" for forward-looking statements. The safe harbor shields an individual defendant from civil liability based on a false forward-looking statement if one of two disjunctive prongs is satisfied: (1) the statement is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement"; or (2) "the plaintiff

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may prosecute under either so long as it does not discriminate against any class of defendants.'" (quoting United States v. Batchelder, 442 U.S. 114, 123–24 (1979))). The dissenting judge rejected this reasoning because it rendered superfluous the materiality requirement contained in the securities laws. *Bilzerian*, 926 F.2d at 1305 (Winter, J., concurring in part and dissenting in part).

[45] *E.g.*, John C. Coffee, Jr., *The Metastasis of Mail Fraud: The Continuing Story of the "Evolution" of a White-Collar Crime*, 21 AM. CRIM. L. REV. 1, 7 (1983) (protesting the extension of criminal liability to the bounds of civil liability).

[46] 521 U.S. 642, 678 n.25 (1997).

[47] *See* 15 U.S.C. § 78t-1 (2006).

[48] When *O'Hagan* was decided, Congress had already prohibited civil plaintiffs from using the Racketeer Influenced and Corrupt Organizations Act ("RICO") to evade the securities laws. *See* 18 U.S.C. § 1964(c) (2006) (containing the amendment that, when pursuing a civil RICO action, "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation").

fails to prove that the forward-looking statement was made with actual knowledge by that person that the statement . . . was false or misleading."[49] For example, if one of the prongs is met, the safe harbor protects "earnings estimates,"[50] predictions that restructuring efforts "will lead to improved profitability,"[51] and expectations that initiatives will "restore" positive cash flow.[52]

Under the plain language of the statute, a defendant is protected from civil liability if a forward-looking statement is accompanied by meaningful cautionary language—regardless of whether the defendant has actual knowledge that the forward-looking statement is false. This interpretation, although dramatic, is supported by the legislative history of the PSLRA,[53] the cases interpreting the safe harbor,[54] and the commentators.[55]

Not surprisingly, virtually every analyst call and SEC filing is accompanied by cautionary language,[56] and the safe harbor is frequently invoked by defendants to shield themselves from civil liability. For instance, out of a set of 248 civil securities fraud opinions issued by federal district courts in 2006 and 2007, the safe harbor was analyzed at least sixty-seven times.[57] In other words,

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[49] 15 U.S.C. § 78u-5(c)(1)(A)(i)–(B)(i) (2006).

[50] Miller v. Champion Enters., Inc., 346 F.3d 660, 677 (6th Cir. 2003).

[51] Theoharous v. Fong, 256 F.3d 1219, 1226 (11th Cir. 2001).

[52] *Id.*

[53] H.R. REP. NO. 104-369, at 44 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 743 ("The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement.").

[54] Southland Sec. Corp. v. Inspire Ins. Solutions, Inc., 365 F.3d 353, 371 (5th Cir. 2004) ("The safe harbor has two independent prongs: one focusing on the defendant's cautionary statements and the other on the defendant's state of mind."); *Miller*, 346 F.3d at 672 ("In other words, if the statement qualifies as 'forward-looking' and is accompanied by sufficient cautionary language, a defendant's statement is protected regardless of the actual state of mind.").

[55] Herbert S. Wander, *Securities Law Disclosure After Sarbanes-Oxley*, SN071 ALI-ABA 797, 899 (2008) (recognizing that the safe harbor permits courts to decide motions to dismiss without examining the defendant's state of mind); Marc H. Folladori, *Protecting Forward-Looking Statements: The Private Securities Litigation Reform Act of 1995 and Other Safeguards*, 14471 PLI/CORP. 505, 538 (2008) ("The two prongs of the Reform Act's safe harbor are stated in the disjunctive and have thus been interpreted as constituting completely separate and distinct routes to gain safe harbor protection . . . . In other words, a forward-looking statement that is known to be false may still be protected if it is immaterial or accompanied by sufficient cautionary language . . . .") (emphasis omitted).

[56] Steven E. Bochner, *Finding the Harbor: Advice for Companies on Navigating Federal Securities Litigation Reform*, FINDLAW, Jan. 1, 1998, http://library.findlaw.com/1998/Jan/1/130350.html ("Registration statements and, increasingly, periodic reports now commonly include safe harbor language.").

[57] The set of 248 opinions was compiled by performing the following "terms and connectors" search in the DCT Westlaw database: ti("securities litigation!") & "securities fraud" & "motion

the court addressed the safe harbor in twenty-seven percent of the opinions. Moreover, the safe harbor is so effective at protecting forward-looking statements that the number of securities class actions alleging false predictions has continued to decline.[58]

The safe harbor does not protect a defendant from criminal liability, however. By its terms, it applies only to "any *private* action arising under this chapter."[59] As a result, a defendant who makes a false forward-looking statement accompanied by meaningful cautionary language is shielded from civil liability but may be criminally prosecuted. For example, corporate executives have been indicted for making the following allegedly false predictions:

> WorldCom is certainly not immune to the effects of the economy. We are being impacted like everyone else. But, with the visibility we have in our significant growth engines, we continue to have confidence in our ability to achieve our [twelve] to [fifteen percent] 2001 growth target on the WorldCom tracker. And I guess the thing that always frustrates me when I hear people talk about visibility as it's kind of like landing a plane—how much visibility do you really have? And so I thought I would just compare it to a weather forecast and say that if we look out for the remainder of 2001, we do not see any storms on the horizon at this time.[60]

"[W]e may well have that asset and operate that asset for quite

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to dismiss" & da(aft 12/31/2005) & da(bef 1/1/2008). This search query retrieved all federal district court opinions published in 2006 or 2007 with the words "securities litigation" in the title and the terms "securities fraud" and "motion to dismiss" in the text. The subset of sixty-seven opinions was compiled by adding the following additional search terms to the query: & ("safe harbor" "meaningful cautionary language"). This search query narrowed the results to only those in which either the phrase "safe harbor" or the phrase "meaningful cautionary language" appears in the text.

[58] *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2007: A YEAR IN REVIEW 20 (2007), http://securities.cornerstone.com/pdfs/YIR2007.pdf ("The percentage of filings alleging false forward-looking statements continued to modestly decline, with only [sixty-three] percent of cases containing such allegations this year [2007] as opposed to [seventy-one] percent in 2006."); *see also* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2006: A YEAR IN REVIEW 18–19 (2006), http://securities.cornerstone.com/pdfs/YIR2006.pdf ("[W]hile the percentage of filings alleging false forward looking statements had increased last year (from [sixty-seven] percent in 2004 to [eighty-two] percent in 2005), 2006 suggests a modest downward reversion with only [seventy-three] percent of cases containing such allegations.").

[59] 15 U.S.C. § 78u-5(c)(1) (2000) (emphasis added).

[60] Indictment at 20–21, United States v. Ebbers, No. S3:02-CR-1144-BSJ (S.D.N.Y. May 24, 2004) (quoting Bernard Ebbers' statements in an April 26, 2001 analyst call), *available at* http://www.usdoj.gov/dag/cftf/cases_q_z.htm.

some time. It's not a bad asset, it's a good asset, just like a lot of the other assets in this portfolio."[61]

In the context of civil securities litigation, these defendants would have had a strong argument that their predictions were protected by the safe harbor, but that argument was not available in their criminal cases.

### *C. Aiders and Abettors of Securities Fraud Are Subject to Criminal Liability but Not Private Civil Liability.*

Supreme Court precedent and congressional statutes interact to cause the following result: aiding and abetting securities fraud is criminally actionable and enforceable by the SEC, but private plaintiffs may not recover damages from anyone but primary violators of the securities laws.

In 1994, overruling "decades of lower court precedent that nearly universally recognized the propriety of . . . secondary liability,"[62] the Supreme Court in *Central Bank of Denver v. First Interstate Bank of Denver* held that a private civil plaintiff may not assert a cause of action for aiding and abetting under § 10(b) of the Securities Exchange Act.[63] The Court reasoned that the text of the statute does not mention "aiding" or "abetting"; and the Court inferred that, since Congress did not attach aiding and abetting liability to any of the express causes of action in the securities acts, it would have been unlikely to attach aiding and abetting liability to § 10(b) if it had been an express, rather than an implied, cause of action.[64] The Court's reasoning was widely interpreted as applying equally to abolish SEC enforcement actions against aiders and abettors.[65] The general United States Code provision imposing criminal liability for aiding or abetting an offense against the United States, however, preserved criminal liability for aiding and abetting securities fraud.[66]

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[61] Superseding Indictment at 33–34, United States v. Causey, No. H-04-25 (S.D. Tex. July 7, 2004) (quoting Kenneth Lay's statements in an October 16, 2001 analyst call), *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/usvlay70704ind.pdf.

[62] Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489, 489 (1995).

[63] 511 U.S. 164, 191 (1994).

[64] *Id.* at 175–78.

[65] Steinberg, *supra* note 62, at 497. "Unless Congress swiftly acts to counter the Court's decision, *Central Bank of Denver* will adversely affect the Securities and Exchange Commission's . . . enforcement program . . . ." *Id.* at 489–90 (footnote omitted).

[66] 18 U.S.C. § 2(a) (2000).

In 1995, after debating whether to overrule or ratify *Central Bank*, Congress chose to forge a middle road. Congress declined to amend the Securities Exchange Act to provide for private aiding and abetting liability, reasoning that it would be "contrary to [the bill's] goal of reducing meritless securities litigation."[67] Congress did, however, explicitly recognize the SEC's right to premise enforcement actions on aiding and abetting conduct.[68]

Finally, in 2002, in response to public outcry over recent corporate scandals, Congress commissioned the SEC to conduct a study to determine the number of securities professionals who, during the period from 1998 to 2001, were found to have "aided and abetted a violation of the Federal securities laws."[69] The commissioning of this study implied that, depending on the results, Congress might extend private civil liability to aiders and abettors.[70] The study, published in 2003, reported enforcement actions against 1,713 securities professionals during the time period.[71] Out of these 1,713 securities professionals, only 297 were found to have aided and abetted a violation of the securities laws and, of those, only thirteen were not also found to have committed a primary violation.[72] The results of the study cut two ways. On the one hand, the paucity of aiding and abetting violations suggested that aiding and abetting behavior was not widespread, obviating the need to expand private civil liability. On the other hand, the results suggested that the SEC might not be aggressively pursuing mere aiders and abettors and that the expansion of private civil liability to aiding and abetting conduct would fill that gap.[73] In addition, notably, the study did not address the number of securities professionals criminally convicted of aiding and abetting securities fraud. Congress has not acted in response to the SEC's report, and private

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[67] S. REP. NO. 104-98, at 19 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 698.

[68] 15 U.S.C. § 78t(e) (2000); S. REP. NO. 104-98, at 19 ("The Committee does, however, grant the SEC express authority to bring actions seeking injunctive relief or money damages against persons who knowingly aid and abet primary violators of the securities laws.").

[69] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 703, 116 Stat. 745, 798 (2002).

[70] C. Evan Stewart, *Holding Lawyers Accountable in the Post-Enron Feeding Frenzy*, 34 SEC. REG. & L. REP. 1587, 1587 n.4 (2002) ("The only logical inference is that some members of Congress are contemplating legislation to overturn the Supreme Court's [decision in *Central Bank of Denver*]." (citation omitted)).

[71] REPORT OF THE SECURITIES AND EXCHANGE COMMISSION: SECTION 703 OF THE SARBANES-OXLEY ACT OF 2002, STUDY AND REPORT ON VIOLATIONS BY SECURITIES PROFESSIONALS 5 (2003), http://www.sec.gov/news/studies/sox703report.pdf.

[72] *Id.*

[73] *See generally* Celia R. Taylor, *Breaking the Bank: Reconsidering* Central Bank of Denver *After Enron and Sarbanes-Oxley*, 71 MO. L. REV. 367, 387–88 (2006).

aiding and abetting actions remain unavailable under the federal securities acts.

## *D. Criminal Liability Under State Law Is Sometimes Broader than Civil Liability Under Federal or State Law.*

State criminal offenses are sometimes broader in scope than the civil causes of action that are available to private plaintiffs. Two factors contribute to this effect. First, state securities acts occasionally impose broad criminal liability without creating a companion private right of action—subjecting a white collar defendant to the prospect of criminal sanction but not affording injured investors a remedy. Second, even if a state securities act affords plaintiffs a private right of action, the broad preemption imposed by the Securities Litigation Uniform Standards Act often renders the private cause of action illusory.

### 1. A Few State Securities Acts Impose Broad Criminal Liability Without Creating a Private Right of Action.

New York's securities act, the Martin Act,[74] is a prime example of a state securities act that criminalizes conduct that is not civilly actionable. The Martin Act imposes criminal liability for conduct that would not be civilly or criminally actionable under the federal securities acts, but the Martin Act does not afford injured investors a private right of action.[75]

First, under the Martin Act, an individual defendant is guilty of a misdemeanor, "punishable by a fine of not more than five hundred dollars, or imprisonment for not more than one year or both,"[76] for making a false statement if he or she "(i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made . . . ."[77] In other words, the Martin Act essentially eliminates the scienter requirement,[78] which is an element of both civil and criminal

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[74] N.Y. GEN. BUS. LAW §§ 352–359-h (McKinney 1996).

[75] CPC Int'l Inc. v. McKesson Corp., 514 N.E.2d 116, 119 (N.Y. 1987) (recognizing that the Martin Act does not expressly create a private right of action and refusing to imply such a right).

[76] N.Y. GEN. BUS. LAW § 359-g(2) (McKinney 1996).

[77] N.Y. GEN. BUS. LAW § 352-c(1)(c) (McKinney 1996).

[78] Frank C. Razzano, *The Martin Act: An Overview*, 1 J. BUS. & TECH. L. 125, 129 (2006) ("A showing of neither intent nor scienter is required to prove a violation of the Act and

liability under the federal securities laws. Civil securities fraud requires a showing of at least recklessness,[79] and criminal federal securities fraud requires a showing of willfulness.[80] One commentator has noted that the Martin Act "seems to create strict liability for uttering a false statement."[81] As a result, a defendant who negligently makes a false statement could be held criminally liable under the Martin Act, despite the fact that the same conduct neither implicates federal criminal liability nor affords a civil remedy.[82]

Second, the Martin Act's definition of "security"[83] is potentially more expansive than the definition of "security" under the federal securities acts,[84] including more conduct within its reach than within the scope of the federal securities laws. For example, in 1996, John Moscow, then of the Manhattan District Attorney's Office, issued the following warning to attorneys:

> If any of you participate in the syndication of loans, you are involved in the negotiation, purchase and sale of securities in New York. . . . If any of you participate in transactions involving mineral leases, those are securities. Likewise, a bunch of other things that you might not think of are covered as securities.[85]

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sustain civil liability or criminal culpability, unless a felony is charged. The purpose of the Act is to allow the Attorney General to prosecute acts and practices beyond intentional fraud.").

[79] Miller v. Champion Enters., Inc., 346 F.3d 660, 672 (6th Cir. 2003) (affirming that recklessness is the state of mind required for securities fraud); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 535 (3d Cir. 1999) (affirming that recklessness is the state of mind required for securities fraud); Nic Heuer, Les Reese & Winston Sale, *Securities Fraud*, 44 AM. CRIM. L. REV. 955, 964–65 & n.51 (2007) (compiling cases).

[80] 15 U.S.C.A. § 78ff(a) (West 1997 & Supp. 2008) (criminalizing "willful violations" of the securities laws); Heuer, Reese & Sale, *supra* note 79, at 958.

[81] Razzano, *supra* note 78, at 128 n.21.

[82] *See* Johnathan Mathiesen, *Dr. Spitzlove or: How I Learned to Stop Worrying and Love "Balkanization,"* 2006 COLUM. BUS. L. REV. 311, 316 (noting that the Martin Act "affords extraordinary leverage as a prosecutorial weapon in part from its lack of a scienter requirement").

[83] N.Y. GEN. BUS. LAW § 352(1) (McKinney 1996) (defining "security" to include "any stocks, bonds, notes, evidences of interest or indebtedness or other securities, including oil and mineral deeds or leases and any interest therein, sold or transferred in whole or in part to the purchaser where the same do not effect a transfer of the title in fee simple to the land, or negotiable documents of title, or foreign currency orders, calls or options therefor[e]").

[84] 15 U.S.C.A. § 77b(a)(1) (West 1997 & Supp. 2008) (defining "security" under the 1933 Act); 15 U.S.C.A. § 78c(a)(10) (West 1997 & Supp. 2008) (defining "security" under the 1934 Act); Wendy Gerwick Couture, *The Securities Acts' Treatment of Notes Maturing in Less Than Nine Months: A Solution to the Enigma*, 31 SEC. REG. L.J. 496, 497 (2003) (attempting to reconcile the discrepancies between the definitions in the 1933 Act and the 1934 Act).

[85] John Moscow, *International Securities Disputes*, 7 WORLD ARB. & MEDIATION REP. 244,

Finally, consistent with its broad purpose of "prevent[ing] all kinds of fraud in connection with the sale of securities and commodities and to defeat all unsubstantial and visionary schemes in relation thereto whereby the public is fraudulently exploited,"[86] the Martin Act is generally interpreted more loosely than its federal counterpart.[87] The terms of the Act are given a wide meaning, so as to include all acts which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law.[88] As a result, it is possible to be convicted for conduct under the Martin Act that is neither civilly nor criminally actionable under the federal securities laws. For example, in a recent case, a defendant convicted of a Martin Act violation for failing to make certain disclosures in SEC filings argued on appeal that one of the disclosures was not required under federal law and could not, therefore, form the basis of state criminal liability.[89] The appellate court rejected this argument as unavailing because federal law does not preempt state law in this context.[90]

New York's criminalization of conduct not civilly actionable has a sweeping impact because of the Martin Act's broad reach. The criminal provisions apply to all false statements "engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities."[91] This territorial reach is arguably satisfied in virtually every case involving a publicly traded security because the New York Stock Exchange is located in New York, the National Association of Securities Dealers Automated Quotation System ("NASDAQ") is headquartered in New York,[92] and business

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244 (1996).

86 People v. Federated Radio Corp., 154 N.E. 655, 657 (N.Y. 1926).

87 State v. McLeod, No. 403855/02, 2006 WL 1374014, at *6 n.8 (N.Y. Sup. Ct. Feb. 9, 2006) ("Because that activity resulted in Ebbers' conviction of federal securities fraud, and because the Martin Act requires less stringent proof than the federal securities laws do, it is clear that Ebbers could also be found liable for violating the Martin Act.").

88 *Id.* at *4.

89 Brief for Defendant-Appellant Kozlowski, People v. Kozlowski, 846 N.Y.S.2d 44 (N.Y. App. Div. Oct. 3, 2006) (No. 5259/02), 2006 WL 2993199 ("[T]he defendants may well have been convicted for failing to volunteer information in federal filings that they were not required to disclose . . . .").

90 People v. Kozlowski, 846 N.Y.S.2d 44 (N.Y. App. Div. 2007).

91 N.Y. GEN. BUS. LAW § 352-c(1)(c) (McKinney 1996). This territorial reach is consistent with the general geographical scope of New York's penal laws. *See* N.Y. CRIM. PROC. LAW § 20.20 (McKinney 2003) (defining the geographical jurisdiction of New York's offenses).

92 *See* NASDAQ, Contact NASDAQ, http://www.nasdaq.com/help/contactInformation.stm (last visited Dec. 2, 2008).

transactions are routinely negotiated and financed in New York.[93] New York's state prosecutors have certainly interpreted the territorial reach of the Martin Act's criminal provisions broadly. For example, Mr. Moscow gave the following example of the breadth of the Martin Act's criminal provisions: "There was one Japanese swindler who committed a fraud from Miami on some people in Denver who is being prosecuted in New York because the stock was offered for sale here. His fraud affected the market price, and he is covered by the statute."[94]

2. State Securities Acts May Purport to Impose Broad Criminal and Civil Liability, but the Civil Liability Is Preempted.

Many state securities acts purport to expand the scope of criminal and civil liability beyond the scope of civil liability under the federal securities acts. For example, most state securities acts extend civil and criminal liability to aiders and abettors rather than merely to primary violators.[95] Further, state securities acts usually do not include safe harbors for forward-looking statements.[96]

These broad state civil liability provisions are preempted, however, when asserted in most class actions.[97] In general, the Securities Litigation Uniform Standards Act ("SLUSA") authorizes the removal and dismissal of state law class actions[98] alleging fraud

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[93] Aaron M. Tidman, Note, *Securities Law Enforcement in the Twenty-First Century: Why States Are Better Equipped Than the Securities and Exchange Commission to Enforce Securities Law*, 57 SYRACUSE L. REV. 379, 391–92 (2007) ("Almost all public companies are traded in New York on the NYSE or the NASDAQ, so almost all securities touch the state and fall within the Martin Act's jurisdiction.").

[94] *See* Moscow, *supra* note 85, at 246.

[95] David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 3 (1998) ("Most state blue-sky laws, by contrast, afford investors broader relief than currently available under federal law, including . . . aiding and abetting liability."); Steinberg, *supra* note 62, at 512 (1995) ("A number of the state statutes extend liability exposure to those who materially aid in consummating the transaction."); Richard H. Walker, David M. Levine & Adam C. Pritchard, *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641, 677 (1997) (noting the allure of aiding and abetting liability under state securities law); *see also supra* text accompanying notes 62–73 (discussing in detail aider and abettor liability under the federal securities laws).

[96] *See* Levine & Pritchard, *supra* note 95, at 12 (recognizing the absence of state court safe harbors for forward-looking statements); *see also supra* text accompanying notes 49–55 (discussing in detail the safe harbor for forward-looking statements under the federal securities laws).

[97] Levine & Pritchard, *supra* note 95, at 3 ("The Uniform Standards Act makes federal antifraud provisions, governed by the Reform Act, the exclusive national standard for most securities fraud class actions.").

[98] In general, SLUSA applies to lawsuits in which damages are sought on behalf of more

in connection with the purchase or sale of securities that are traded nationally and listed on a regulated national exchange.[99] As a result, the expansive civil liability available under state securities law is often rendered illusory.[100]

SLUSA does not, however, preempt criminal prosecutions. After the civil liability provisions of state securities acts are preempted by SLUSA, the broad criminal liability provisions remain. As a consequence, state securities acts that impose liability beyond the scope of civil liability under the federal securities acts effectively criminalize conduct that is not civilly actionable.

### *E. Criminal Indictments Are Less Likely to Be Dismissed Pretrial than Civil Complaints.*

In addition to substantive differences between criminal and civil enforcement of securities fraud, procedural differences contribute to the anomalous result that a defendant may be held criminally liable despite the fact that a civil lawsuit based on the same allegations would not survive dismissal. First, the pleading standards are far stricter for civil securities fraud complaints than for criminal securities fraud indictments. Second, motions to dismiss are more favored in civil securities fraud cases than in criminal cases. As a result, far more civil securities fraud cases are dismissed pretrial than criminal cases.

#### 1. The PSLRA's Pleading Standards Are Stricter than the Pleading Standards for Criminal Indictments.

In 1995, Congress, with the goal of curtailing abusive strike suits, imposed strict pleading standards for private securities litigation.[101] In order to survive dismissal for failure to satisfy these pleading standards, a complaint must "specify each statement alleged to have

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than 50 people. 15 U.S.C. § 78bb(f)(5)(B) (2006).

[99] 15 U.S.C. § 77p(b)-(c) (2006); 15 U.S.C. § 77r(b)(1) (2006); Levine & Pritchard, *supra* note 95, at 14 (explaining that SLUSA "preempts most securities fraud class actions brought in state court").

[100] Levine & Pritchard, *supra* note 95, at 3 ("The Uniform Standards Act makes federal antifraud provisions, governed by the Reform Act, the exclusive national standard for most securities fraud class actions.").

[101] S. REP. NO. 104-98, at 15 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 694 ("The Securities Subcommittee has heard ample testimony on the need to establish a uniform and stringent pleading requirement to curtail the filing of abusive lawsuits."); Wander, *supra* note 55, at 894 (explaining that "[p]leading standards were raised, especially those regarding 'state of mind allegations,' i.e. scienter").

been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[102] Moreover, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[103] These stringent pleading standards, which must be satisfied before a plaintiff has performed any discovery,[104] nip in the bud many civil securities fraud cases.[105]

Unlike a civil securities fraud complaint, a criminal indictment need not allege fraud with particularity. An indictment need only be "a plain, concise, and definite written statement of the essential facts constituting the offense charged."[106] In other words, an indictment is sufficient as long as it "'(1) contains the elements of the offense intended to be charged, (2) sufficiently apprises the defendant of what he must be prepared to meet, and (3) allows the defendant to show with accuracy to what extent he may plead a former acquittal or conviction in the event of a subsequent prosecution.'"[107]

As a result of these different pleading standards, a complaint and an indictment containing identical securities fraud allegations could be treated quite differently. Theoretically, the civil complaint could be dismissed under the PSLRA, while the criminal indictment could survive dismissal.

### 2. Pretrial Motions to Dismiss Are More Favored in Civil Securities Fraud Cases than in Criminal Cases.

The motion to dismiss is an essential step in a civil securities

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[102] 15 U.S.C. § 78u-4(b)(1) (2006); Southland Secs. Corp. v. Inspire Ins. Solutions, Inc., 365 F.3d 353, 362–63 (5th Cir. 2004) ("The PSLRA reinforces the particularity requirements of Rule 9(b), requiring the plaintiffs to state not only the time, place, the identity of the speaker, and the content of the alleged misrepresentation, but also to explain why the challenged statement or omission is false or misleading.").

[103] 15 U.S.C. § 78u-4(b)(2) (2006).

[104] 15 U.S.C. § 78u-4(b)(3)(B) (2006).

[105] City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 682 (6th Cir. 2005) ("[T]o survive a motion to dismiss, a federal securities fraud claim must 'withstand an exacting statement-by-statement analysis' . . . ." (quoting *In re* First Union Corp. Sec. Litig., 128 F. Supp. 2d 871, 886 (W.D.N.C. 2001))); Bainbridge & Gulati, *supra* note 21, at 131 (recognizing that "particularity requirements serve as a quick and easy way of getting rid of securities fraud cases").

[106] FED. R. CRIM. P. 7(c)(1).

[107] United States v. Kemp, 500 F.3d 257, 280 (3d Cir. 2007) (quoting United States v. Vitillo, 490 F.3d 314, 321 (3d Cir. 2007)).

fraud lawsuit. The Federal Rules of Civil Procedure explicitly recognize the availability of a motion to dismiss for "failure to state a claim upon which relief can be granted,"[108] and the PSLRA instructs that a court "shall, on the motion of any defendant, dismiss the complaint" if the pleading requirements are not met.[109] In fact, commentators have characterized the motion to dismiss stage as "the primary battleground in the securities class action area."[110]

A motion to dismiss a criminal indictment is less favored. The Federal Rules of Criminal Procedure do not explicitly recognize the right to file a motion to dismiss an indictment, but Rule 12(b)(2) does allow a party to "raise by pretrial motion any defense, objection, or request that the court can determine without a trial of the general issue."[111] Among other issues that can be determined without a trial,[112] the failure of an indictment to allege conduct within the scope of a criminal statute is properly raised with a Rule 12(b)(2) motion.[113] As a practical matter, however, motions to dismiss criminal indictments are rarely asserted. In fact, the "system overview" prepared by the DOJ, which charts the progress of a criminal case from arrest through eventual release from prison, does not even recognize a motion to dismiss stage of the proceedings.[114]

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[108] FED. R. CIV. P. 12(b)(6).

[109] 15 U.S.C. § 78u-4(b)(3)(A) (2006).

[110] Bainbridge & Gulati, *supra* note 21, at 116 n.94.

[111] FED. R. CRIM. P. 12(b)(2). The prior version of this rule explicitly recognized the right to file a motion to dismiss: "defenses and objections raised before trial which heretofore could have been raised by one or more of them [i.e., pleas, demurrers, or motions to quash] shall be raised only by motion to dismiss or to grant appropriate relief, as provided in these rules." FED. R. CRIM. P. 12(a) (amended in 2002). "This provision was deleted in 2002 as unnecessary." 1A CHARLES ALAN WRIGHT & ANDREW LEIPOLD, FEDERAL PRACTICE AND PROCEDURE § 191 (4th ed. 2008).

[112] WRIGHT & LEIPOLD, *supra* note 111, § 191 ("A Rule 12 motion is thus the proper method to raise such matters as: the regularity of the proceedings of the grand jury; the sufficiency of the indictment or information; requests for severance or the propriety of joinder of offenses or defendants; the propriety of venue; double jeopardy; bills of particulars; depositions and discovery; transfer to another place for trial; suppression of evidence; dismissal for want of a speedy trial; and other matters that can be determined without a trial." (footnotes omitted)).

[113] United States v. Panarella, 277 F.3d 678, 685 (3d Cir. 2002) ("[F]or purposes of Rule 12(b)(2), a charging document fails to state an offense if the specific facts alleged in the charging document fall beyond the scope of the relevant criminal statute, as a matter of statutory interpretation.").

[114] *See* BUREAU OF JUSTICE STATISTICS, U.S. DEP'T OF JUSTICE, COMPENDIUM OF FEDERAL JUSTICE STATISTICS, 2004 7 fig.S.1 (2004), *available at* http://www.ojp.usdoj.gov/bjs/pub/pdf/cfjs04.pdf.

3. More Civil Securities Fraud Cases Are Dismissed Pretrial than Criminal Securities Fraud Cases.

As a result of these two procedural differences—the pleading standard and the prevalence of motions to dismiss—far more civil securities fraud cases are dismissed pretrial than criminal securities fraud cases.

A large percentage of motions to dismiss civil securities fraud complaints are granted.[115] According to a report published by Cornerstone Research, for each year from 2001 through 2005, an average of thirty-eight percent of the securities class actions filed each year were dismissed.[116] This average excludes cases that were resolved through settlement and dismissed by agreement.[117] The percentage increases if partial dismissals are taken into account. According to one survey, seventy-nine percent of motions to dismiss securities fraud class actions were granted at least in part.[118]

In contrast, few criminal securities fraud cases are dismissed pretrial. According to data compiled by the Federal Justice Statistics Resource Center for the years 2001 through 2006, on average only 8.36% of criminal securities fraud cases were terminated each year by "dismissal or nolle prosequi."[119] This statistic does not differentiate between those cases dismissed on the prosecutor's motion and those dismissed on the defendant's motion. Even assuming that all of these dismissals were on the basis of defendants' motions to dismiss, the percentage of securities fraud dismissals in criminal cases is dwarfed by the number in civil cases.

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[115] Wander, *supra* note 55, at 916 ("[M]ore cases are being dismissed at the pleading stage.").

[116] *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS, 2007: A YEAR IN REVIEW 14 ex. 14 (2007), *available at* http://securities.cornerstone.com/pdfs/YIR2007.pdf. According to this report, 32% of the securities class action cases filed in 2001, 34% of the cases filed in 2002, 42% of the cases filed in 2003, 43% of the cases filed in 2004, and 38% of the cases filed during 2005 were resolved through dismissal. *Id.* The data on dismissals for cases filed in 2006 and 2007 is not included in the average cited by this article because motions to dismiss have not yet been decided in many of these cases, resulting in a higher percentage of continuing cases and a lower percentage of dismissals.

[117] *Id.*

[118] Bainbridge & Gulati, *supra* note 21, at 116 n.94 (finding that seventy-two out of ninety-one motions were granted in full or in large part).

[119] *See* Federal Justice Statistics Res. Ctr., http://fjsrc.urban.org/index.cfm. The data can be selected for the following variables: (1) statistic, here "outcomes for defendants in cases closed;" (2) year, here 2001 through 2006; and (3) type of charge, here 15 U.S.C. § 78j. In 2006, 17 of 108 securities fraud cases were terminated by dismissal or nolle prosequi. In 2005, 3 of 95 were terminated; in 2004, 8 of 57 were terminated; in 2003, 9 of 108 were terminated; in 2002, 3 of 95 were terminated; and in 2001, 4 of 64 were terminated.

The disparity in dismissal figures does not compel the conclusion that the same allegations are more likely to proceed to trial in a criminal case than in a civil case. Arguably, prosecutors in the exercise of their discretion are less likely to pursue unmeritorious claims than civil plaintiffs in a strike suit. Nonetheless, these procedural differences, at the very least, intensify the substantive differences addressed above, exacerbating the anomalous result in which a defendant can be held criminally but not civilly liable for the same conduct.

### *F. The Higher Mental State Generally Required for Criminal Liability Does Not Cure the Anomaly.*

The mental state required to establish criminal liability under federal law is ostensibly higher than the mental state required to establish civil liability. This difference, however, is unlikely to close the gap between civil and criminal liability for conduct sounding in securities fraud because essentially the same evidence is sufficient in both contexts.

Civil securities fraud requires a showing of scienter, which is ordinarily defined as "recklessness."[120] A reckless statement is one "'involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'"[121] A few circuits require "'severe recklessness'"[122] or a "'high degree of recklessness.'"[123] If the allegedly false statement is forward-looking, the scienter requirement is raised to "actual knowledge."[124]

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[120] Miller v. Champion Enters., Inc., 346 F.3d 660, 672 (6th Cir. 2003) (affirming that "recklessness" is the state of mind required for securities fraud); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 535 (3d Cir. 1999) (affirming that "recklessness" is the state of mind required for securities fraud); Heuer, Reese & Sale, *supra* note 79, at 964 ("The Seventh Circuit has permitted a defendant's reckless action to meet the scienter requirement, and most circuits have followed suit . . . .").

[121] *In re Advanta Corp.*, 180 F.3d at 535 (quoting McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979)).

[122] Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc., 497 F.3d 546, 551 (5th Cir. 2007) (stating that scienter means "either intent *or severe recklessness*" (quoting Fin. Acquisition Partners, L.P. v. Blackwell, 440 F.3d 278, 287 (5th Cir. 2006))).

[123] Miss. Pub. Employees' Ret. Sys. v. Boston Scientific Corp., 523 F.3d 75, 85 (1st Cir. 2008) ("This circuit has held that a plaintiff can demonstrate scienter by showing that defendants either 'consciously intended to defraud, or that they acted with a high degree of recklessness.'" (quoting Aldridge v. A.T. Cross Corp., 284 F.3d 72, 82 (1st Cir. 2002))).

[124] 15 U.S.C. § 78u-5(c)(1)(B)(i) (2000).

Criminal securities fraud, on the other hand, requires a showing of "willfulness."[125] Willfulness requires "intentionally undertaking an act that one knows to be wrongful."[126] Mail and wire fraud, similarly, require proof of the "specific intent to defraud."[127] The specific intent to defraud has been defined as "'willful participation in a scheme with knowledge of its fraudulent nature and with intent that these illicit objectives be achieved,'"[128] as "conscious knowing intent to defraud,"[129] and as "reckless indifference."[130]

Although the criminal mental states are more stringent than civil scienter, this difference is diminished by the practicality of how a defendant's mental state is proven at trial. Direct evidence of a defendant's mental state is unusual; ordinarily, a person's mental state must be inferred from indirect evidence.[131] Prosecutors, therefore, use circumstantial evidence to prove that a defendant possessed the requisite criminal mental state.[132] A defendant's mens rea "may be inferred from the defendant's statements and conduct,"[133] "evidence of actual or contemplated harm,"[134] "a defendant's reckless indifference to the truth of a representation,"[135]

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[125] 15 U.S.C. § 78ff(a) (2000) (criminalizing "willful violations" of the securities laws); Heuer, Reese & Sale, *supra* note 79, at 958–59 ("The only difference is that in order for criminal liability to attach, a showing of willfulness is required in addition to the elements of a civil claim under Rule 10b-5.").

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

[127] United States v. Lucas, 516 F.3d 316, 339 (5th Cir. 2008), *cert. denied*, 2008 WL2307360 (2008) (holding that a mail fraud conviction requires the "'specific intent to defraud.'" (quoting United States v. Dotson, 407 F.3d 387, 391–92 (5th Cir. 2005))); United States v. Brown, 459 F.3d 509, 519 (5th Cir. 2006) ("Violation of the wire-fraud statute requires the specific intent to defraud . . . ."); United States v. Manion, 339 F.3d 1153, 1156 (9th Cir. 2003) (holding that in order to convict of mail or wire fraud the government must "show specific intent to defraud").

[128] *Manion*, 339 F.3d at 1156 (quoting United States v. Price, 623 F.2d 587, 591 (9th Cir. 1980), *overruled by* United States v. DeBright, 730 F.2d 1255 (9th Cir. 1984)).

[129] *Brown*, 459 F.3d at 519 (quoting United States v. Reyes, 239 F.3d 722, 736 (5th Cir. 2001)).

[130] *See* CRIMINAL RESOURCE MANUAL, *supra* note 29, § 9-1520 (instructing that "[f]raudulent intent is shown if a representation is made with reckless indifference to its truth or falsity").

[131] Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1221 (1985) ("Unless the criminal defendant confesses or makes damaging admissions, his state of mind has to be inferred from external acts . . . .").

[132] Heuer, Reese & Sale, *supra* note 79, at 996 ("[S]ome cases suggest that the government's burden of proving intent may be met using only circumstantial evidence.") (compiling cases); CRIMINAL RESOURCE MANUAL, *supra* note 29, § 9-1520 (instructing that fraudulent intent may be inferred).

[133] United States v. Sayakhom, 186 F.3d 928, 941 (9th Cir. 1999).

[134] United States v. Welch, 327 F.3d 1081, 1105 (10th Cir. 2003).

[135] *Id.*; *see also* United States v. Tarallo, 380 F.3d 1174, 1189 & n.5 (9th Cir. 2004) (holding "that recklessness is adequate to support a conviction for securities fraud" and that this

"misrepresentations made by the defendants, and the scheme itself."[136] It is unlikely, therefore, that a cognizable difference exists between the proof needed to prove criminal intent and the proof needed to satisfy civil scienter.[137] Moreover, in light of the PSLRA's heightened pleading standards for scienter, which require a civil plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,"[138] it is arguable that the scienter bar in civil cases is actually higher than the mens rea bar in criminal cases.

Indeed, defendants charged with criminal securities fraud have found the purportedly higher criminal mental state to be of little comfort. Juries are comfortable convicting defendants of fraud based on circumstantial evidence that directly conflicts with the defendants' testimony on the witness stand. For example, despite denying "playing any role in the $11 billion accounting fraud at the telecommunications company," WorldCom CEO Bernard Ebbers was convicted of fraud.[139] Likewise, despite testifying that

> [t]he last thing I would do is step back in as CEO and pick up leadership of a conspiracy, having lived my whole life in such a way to make sure that I was doing at least what I thought, according to my moral code of conduct and according to my religious faith, was right or wrong,[140]

Enron CEO Kenneth Lay was convicted of securities and wire fraud.[141]

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standard is consistent with the definition of "willful").

[136] United States v. Sullivan, 522 F.3d 967, 974 (9th Cir. 2008) (citation omitted).

[137] Heuer, Reese & Sale, *supra* note 79, at 966 ("It is debatable whether willfulness in criminal cases requires something above the ordinary scienter required in civil cases."); Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 1021 (1985) (recognizing "the possible anomaly that the same degree of culpability applies in both criminal actions . . . and civil actions" (emphasis omitted)).

[138] 15 U.S.C. § 78u-4(b)(2) (2000); Southland Secs. Corp. v. Inspire Ins. Solutions, Inc., 365 F.3d 353, 362–63 (5th Cir. 2004) ("The PSLRA reinforces the particularity requirements of Rule 9(b), requiring the plaintiffs to state not only the time, place, the identity of the speaker, and the content of the alleged misrepresentation, but also to explain why the challenged statement or omission is false or misleading.").

[139] *MCI-WorldCom Timeline, 1983–Present*, FOXNEWS.COM, Mar. 15, 2005, http://foxnews.com/story/0,2933,150521,00.html (reporting that, on February 28, 2005, former WorldCom CEO Bernard Ebbers took the witness stand and denied any role in the fraud and that, on March 1, 2005, Ebbers was found guilty of fraud).

[140] Transcript of Testimony of Kenneth Lay, United States v. Causey, 356 F. Supp. 2d 681 (S.D. Tex. 2006) (No. H-04-25), *available at* http://www.chron.com/news/specials/enron/background.html (follow "Pain of Bankruptcy" hyperlink).

[141] *See A Timeline of the Rise & Fall of Enron*, CHRON.COM,

## III. DIFFERING CIVIL AND CRIMINAL TREATMENT OF CONDUCT SOUNDING IN SECURITIES FRAUD MAY AFFECT THE CURRENT SCHEME OF SECURITIES REGULATION.

The current scheme of securities regulation reflects a delicate balance among numerous considerations. The imposition of criminal punishment for conduct that does not invoke civil liability risks disrupting this balance, potentially at the expense of considerations deemed important by Congress and the courts.

### *A. The Wire/Mail Fraud Run-Around May Disrupt the Balance Between Honest Markets and Optimal Levels of Disclosure.*

When adopting the objective materiality standard for securities fraud, the Supreme Court balanced several competing considerations. On the one hand, the Supreme Court recognized the fundamental importance of fair and honest markets.[142] The Supreme Court identified "honest publicity" as an essential tool to prevent manipulation and dishonest market practices.[143] This consideration weighed in favor of a low standard of materiality—both to lower the bar for required disclosures and to limit the number of affirmative false statements. On the other hand, the Supreme Court recognized the dangers of setting the materiality standard too low. When applied to omissions by a company, "a minimal standard might bring an overabundance of information within its reach, and lead management 'simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.'"[144] The Supreme Court adopted an objective materiality standard designed to achieve

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http://www.chron.com/news/specials/enron/timeline (last visited Nov. 30, 2008) (web version of the *Houston Chronicle*). Because Lay died before his appeals were exhausted, his conviction was vacated on October 17, 2006. *Id.*

142 Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) (recognizing that a central purpose of the securities laws is "to protect investors against manipulation of stock prices"); *see also* 15 U.S.C. § 78b (2000) (stating that one purpose of securities regulation is "to insure the maintenance of fair and honest markets").

143 *Basic*, 485 U.S. at 230 ("'There cannot be honest markets without honest publicity.'" (quoting H.R. REP. NO. 73-1383, at 11 (1934))); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (stating that the purpose of the securities law is "to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing").

144 *Basic*, 485 U.S. at 231 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976)).

a delicate balance between these competing concerns to protect the integrity of the markets and to encourage the appropriate level of disclosure.[145]

The importance of the balance achieved by the materiality standard has been widely acknowledged. In fact, the necessity of preserving the materiality balance spurred Congress to amend the Racketeer Influenced and Corrupt Organizations Act ("RICO"). Prior to the passage of the PSLRA, plaintiffs could premise civil RICO claims sounding in securities fraud on violations of the mail and wire fraud statutes—thus avoiding the more stringent requirements of a securities fraud claim.[146] This run-around was widely criticized. For example, Justice Thurgood Marshall recognized that the use of civil RICO to pursue claims sounding in securities fraud "virtually eliminates decades of legislative and judicial development of private civil remedies under the federal securities laws."[147] Justice Marshall identified materiality as one of the crucial issues that RICO allowed plaintiffs to bypass.[148] The PSLRA closed this door by prohibiting civil RICO claims from being premised on claims that sound in securities fraud.[149] Although the same argument ostensibly applies in the criminal context, Congress left the wire/mail fraud run-around open to prosecutors.

The lower materiality standard available via the wire/mail fraud run-around risks disrupting the delicate balance achieved with the objective materiality standard.[150] The goal of encouraging fair and honest markets is furthered at the expense of the goal of achieving

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[145] *Id.* at 249.

[146] *See* H.R. REP. NO. 104-369, at 47 (1995) (Conf. Rep.) ("[With this amendment], the Conference Committee intends that a plaintiff may not plead other specified offenses, such as mail or wire fraud, as predicate acts under civil RICO if such offenses are based on conduct that would have been actionable as securities fraud.").

[147] Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 505 (1985) (Marshall, J., dissenting).

[148] *Id.* ("All of this law is now an endangered species because plaintiffs can avoid the limitations of the securities laws merely by alleging violations of other predicate acts.").

[149] 18 U.S.C. § 1964(c) (2000) ("[N]o person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962.").

[150] The current materiality standard also achieves a delicate balance between encouraging and discouraging private class actions. An objective materiality standard simultaneously enables and limits private securities class actions. On the one hand, the objective standard permits classwide determination of materiality. On the other hand, the standard bars suit by unreasonable or gullible investors. Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "The Reasonable Investor" with "The Least Sophisticated Investor" in Inefficient Markets*, 81 TUL. L. REV. 473, 486–89 (2006) (detailing how the objective materiality standard embodies these conflicting mindsets). This balance is not upset by the wire/mail fraud run-around, which does not affect private class actions.

the appropriate amount of disclosure. The lower materiality standard compels disclosure of objectively unimportant details of a corporate event, flooding the market with too much information. By the same token, the lower materiality standard inhibits corporate executives from making voluntary statements to analysts and investors, for fear that their offhand remarks could form the basis of a wire fraud indictment.[151] The chilling effect of the lower materiality standard is compounded by the overdeterrence effect of criminal liability, which discourages even borderline behavior.[152]

In other words, the wire/mail fraud run-around risks changing the entire scheme of corporate disclosure.[153] Already, attorneys caution their corporate clients that "[s]lips of the [t]ongue and [p]en [a]re [d]angerous."[154] In light of the wire/mail fraud run-around, corporate counsel should warn their clients that off-the-cuff remarks risk imprisonment. The current editions of the National Investor Relations Institute's *Standards of Practice for Investor Relations*[155] and the Practicing Law Institute's *Policy Statement Concerning Disclosure of Material Information* continue to define materiality as an objective standard,[156] but these corporate handbooks should be amended to reflect the subjective materiality standard compelled by the wire/mail fraud run-around.

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151 Hoffman, *supra* note 20, at 599–600 (recognizing the relationship between a strict materiality standard and corporate disclosure and, based on the strength of the immateriality doctrine in civil litigation, predicting increased corporate disclosure).

152 RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 224 (4th ed. 1992) ("[A] savage penalty will induce people to forgo socially desirable activities at the borderline of criminal activity."); Coffee, *supra* note 45, at 9 (recognizing that the liberal construction of criminal laws influences "risk averse citizens who change their behavior to stay comfortably distant from a vague, shifting line"); Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1, 14 (1990) ("High criminal penalties will deter people from desirable, but only marginally lawful, activity because they are uncertain whether they will be convicted of a crime.").

153 Michael R. Dreeben, now a Deputy Solicitor General in the Office of the Solicitor General, U.S. Department of Justice, recognized a comparable risk in the use of the "intangible rights doctrine" of mail fraud to prosecute corporate officers for failing to disclose information to the public shareholders, despite the fact that the securities laws may not have required the disclosure. Michael R. Dreeben, *Insider Trading and Intangible Rights: The Redefinition of the Mail Fraud Statute*, 26 AM. CRIM. L. REV. 181, 190–91 (1988). Mr. Dreeben noted that this application of the mail fraud statute "came at the expense of the securities law policies that Congress, the SEC, and the courts had developed to structure the behavior of corporate officers and directors." *Id.* at 191.

154 Wander, *supra* note 55, at 846.

155 NAT'L INVESTOR RELATIONS INST., STANDARDS OF PRACTICE FOR INVESTOR RELATIONS 22 (3d ed. 2004) (premising disclosure requirements on a statement's materiality, as objectively defined under the securities laws).

156 PRACTISING LAW INSTITUTE, CORPORATE LAW AND PRACTICE, PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2008, 648–49 (2008) (defining materiality as an objective standard).

### *B. The Wire/Mail Fraud Run-Around May Affect What Information Investors Rely Upon When Making Investment Decisions.*

A key assumption underlying the securities fraud materiality standard is that stock purchasers expect a company's representatives to make puffing statements and thus lend them no credence.[157] In other words, it is assumed that "reasonable" investors disregard some statements by corporate officers. Of course, this assumption is self-perpetuating. Presumably, one of the reasons that reasonable investors discount puffing statements is their understanding that these types of statements cannot support a securities fraud claim.

The use of a subjective materiality standard to prosecute corporate officers for wire or mail fraud may encourage investors to lend credence to vague statements of corporate optimism, undercutting the assumption that investors disregard puffery. Recognizing that corporate officers can face imprisonment for a false statement of corporate optimism, investors may begin to take every statement—even a puffing one—at face value. In effect, the prosecution of corporate officers for puffery could create a class of investors who make investment decisions on the basis of vague statements of corporate optimism rather than on statements of fact.

In addition to increasing market volatility, this new class of "gullible" investors could transform the meaning of materiality in the securities fraud context. Arguably, these investors—by taking into account the criminal disincentive facing corporate officers who make false statements of optimism—would be making an objectively reasonable decision to rely on corporate puffery. If courts were to accept this argument, even a vague statement of optimism by a corporate officer could form the basis for civil securities liability. In other words, the objective materiality standard would become coextensive with the subjective standard. As a result, the delicate balance achieved by the objective materiality definition would be disrupted, chilling voluntary disclosure and encouraging the flooding of the market with trivial information.

One commentator has suggested, however, that retail investors (as opposed to institutional investors) already rely on puffery when making investment decisions, that these retail investors are being

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[157] O'Hare, *supra* note 13, at 1721 (identifying "distrust between the buyer and the seller" as an assumption underlying the puffery defense).

driven out of the markets because of the disfavored treatment that they receive under the civil securities laws, and that this is adversely affecting market liquidity.[158] Under this analysis, lowering the securities fraud materiality standard to include puffery would achieve the positive effects of encouraging retail investment and improving market liquidity.

### *C. The Criminalization of Conduct Not Civilly Actionable May Transfer Enforcement Responsibility Away from the Securities and Exchange Commission.*

"The SEC is vested with primary responsibility for enforcing the [Securities Exchange] Act and protecting the public interest."[159] In this role, the SEC's mission "is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[160] As such, the SEC has developed unique expertise in the securities field.[161] The anomaly of criminalizing conduct not civilly actionable may, however, jeopardize the SEC's primacy. The wire/mail fraud run-around may transfer enforcement responsibility away from the SEC to the DOJ, and expansive state securities statutes may transfer enforcement responsibility away from the SEC to the individual states.

First, the wire/mail fraud run-around, which is only available in criminal cases, is out of the SEC's reach. The SEC institutes civil securities fraud enforcement proceedings, while the DOJ institutes criminal prosecutions. The SEC may "in its discretion" refer a matter to the DOJ for prosecution,[162] but the DOJ has independent discretion to prosecute without SEC referral or to refrain from prosecution despite SEC referral.[163] As a consequence, the availability of the wire/mail fraud run-around shifts enforcement

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[158] Jennifer O'Hare, *Retail Investor Remedies under Rule 10B-5*, 76 U. CIN. L. REV. 521, 539, 552–54 (2008).

[159] Union Pac. R.R. v. Chicago & N.W. Ry. Co., 226 F. Supp. 400, 406 (N.D. Ill. 1964); SEC. EXCH. COMM'N, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION (2008), http://www.sec.gov/about/whatwedo.shtml (describing the SEC as "the primary overseer and regulator of the U.S. securities markets").

[160] SEC. EXCH. COMM'N, *supra* note 159.

[161] Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 64 (1977) (recognizing the SEC's expertise in the securities field).

[162] 17 C.F.R. § 202.5(b) (2008).

[163] 17 C.F.R. § 202.5(f) (2008) (recognizing that the Attorney General and the Department of Justice have "the authority and responsibility for instituting, conducting, settling, or otherwise disposing of criminal proceedings"); Heuer, Reese & Sale, *supra* note 79, at 1015.

responsibility from the SEC to the DOJ. The Supreme Court recognized this enforcement policy consideration in *United States v. O'Hagan*.[164] The Court considered whether criminal liability under section 10(b) of the Securities Exchange Act could be based on the misappropriation theory of insider trading.[165] The Eighth Circuit Court of Appeals, refusing to recognize the misappropriation theory, had reversed both the securities fraud counts and the accompanying mail fraud counts because "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud."[166] On appeal, the Supreme Court upheld the misappropriation theory, thus mooting the issue of whether reversal of the securities fraud conviction necessitated reversal of the mail fraud conviction.[167] The majority nonetheless briefly discussed the enforcement considerations implicated by this issue: "[i]f misappropriation theory cases could proceed only under the federal mail and wire fraud statutes, . . . 'proportionally more persons accused of insider trading [might] be pursued by a U.S. Attorney, and proportionally fewer by the SEC.'"[168] Justice Clarence Thomas, in dissent, rejected the misappropriation theory of securities fraud, but stated that the conduct could nonetheless be prosecuted as mail fraud.[169] Justice Thomas disregarded the enforcement considerations raised by the majority as "no business of this Court."[170]

Second, the breadth of civil and criminal enforcement under the state securities statutes—often exceeding the scope of the federal securities laws—may shift enforcement responsibility away from the SEC to the individual states. For example, the Attorney

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164 521 U.S. 642 (1997).

165 *Id.* at 647.

166 United States v. O'Hagan, 92 F.3d 612, 627 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

167 *O'Hagan*, 521 U.S. at 647.

168 *Id.* at 678 n.25 (citing and quoting Barbara Bader Aldave, *The Misappropriation Theory:* Carpenter *and Its Aftermath*, 49 OHIO ST. L.J. 373, 381–82 (1988)). Ten years earlier, in *Carpenter v. United States*, 484 U.S. 19 (1987), the Supreme Court was confronted with a similar case in which the defendants were convicted of securities fraud based on the misappropriation theory and of mail and wire fraud premised on the same conduct. The Court, which was evenly divided on the viability of the misappropriation theory, affirmed the conviction for securities fraud, and—without analyzing the interaction of the securities fraud statute and the wire and mail fraud statutes—affirmed the convictions for wire and mail fraud. *Id.* at 24–28.

169 *O'Hagan*, 521 U.S. at 700–01 (Thomas, J., dissenting) ("[J]ust because those facts are legally insufficient to constitute securities fraud does not make them legally insufficient to constitute mail fraud.").

170 *Id.* at 701 n.13 (Thomas, J., dissenting).

General of New York, exploiting the breadth of the Martin Act, achieved a landmark settlement with Merrill Lynch to prevent analyst conflicts of interest.[171] Theoretically, every state attorney general, if afforded the statutory tools, could force a company to enter into a separate settlement agreement, with the result that the companies would be required to comply with fifty different standards.[172] This effect, the so-called "Balkanization" of securities regulation,[173] has been widely decried as usurping the power of the SEC,[174] preventing uniformity,[175] and undermining market efficiency.[176]

As a practical matter, however, commentators have noted that state enforcement agencies are generally working together with the SEC and with each other to achieve consistency and prevent duplication of efforts.[177] In addition, the tremendous resources required to investigate and prosecute a large-scale securities fraud case are often beyond the reach of individual states, and these cases therefore default to the federal government. For example, during the course of its investigation, the Enron Task Force examined

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171 Agreement between the Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith, Inc., May 21, 2002, *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/merrilllynch/nymerrill52102agr.pdf; Christopher R. Lane, *Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators*, 39 NEW ENG. L. REV. 317, 330–31 (2005) (detailing the events surrounding the Merrill Lynch settlement).

172 Michael G. Oxley, Letter to the Editor, *Who Should Police the Financial Markets?*, N.Y. TIMES, June 9, 2002, § 3, at 11 (predicting that "every Wall Street firm would have to cut its private deal with every state attorney general or face the potential threat of fraud charges").

173 Steve A. Radom, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295, 304 (2003) ("Balkanization refers to the process of political fragmentation, effectuated by breaking up regulatory bodies into smaller, and often hostile, units.").

174 Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 952 (2005) (describing the New York Attorney General as having launched "a 'hostile takeover' of the SEC" (quoting Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 128–133 (2005))).

175 Mathiesen, *supra* note 82, at 313 (questioning whether Balkanization will "wreck the uniform federal scheme with parochial reforms crafted only for their populist ring").

176 Lane, *supra* note 170, at 339 (recognizing the risk that fifty different requirements would "impair the efficiency of the markets").

177 Mathiesen, *supra* note 82, at 322–23 (detailing the coordination among the New York Attorney General, the New York Stock Exchange, the National Association of Securities Dealers, and the SEC to reach a "Global Settlement" to prevent analyst conflicts of interest); Dale A. Oesterle, *Early Observations on the Prosecutions of the Business Scandals of 2002–03: On Sideshow Prosecutions, Spitzer's Clash with Donaldson Over Turf, the Choice of Civil or Criminal Actions, and the Tough Tactic of Coerced Cooperation*, 1 OHIO ST. J. CRIM. L. 443, 469 (2004) (explaining how the attorneys general in ten states divided responsibility for investigating analyst conflicts of interest).

"more than four terabytes of data—equal to about [twenty] percent of all the information stored in the Library of Congress."[178]

*D. The Inapplicability of the Safe Harbor to Criminal Liability May Discourage Forward-Looking Statements.*

Congress intended for the PSLRA's safe harbor for forward-looking statements to encourage corporate executives to make predictions. Congress recognized: "Fear that inaccurate projections will trigger the filing of a securities fraud lawsuit has muzzled corporate management."[179] The safe harbor was meant to allay this fear.[180] Of course, unacknowledged by Congress is that fear of criminal liability is likely to muzzle corporate management even more effectively than the threat of a civil lawsuit. For this reason, the indictment of corporate executives for inaccurate projections is likely to counteract the calming effect of the safe harbor.

*E. The Potential Exposure to Criminal Aiding and Abetting Liability May Discourage Professionals from Advising New Companies.*

In *Central Bank*, the Supreme Court recognized that uncertainty about the scope of aiding and abetting liability could have ripple effects in the economy.[181] The Court warned that less established companies might have trouble finding professionals willing to tender their services and that the price of professional services—taking into account the professional's risk of potential aiding and abetting liability if the company were to fail—might render them out of reach.[182] The Court recently reiterated these concerns with private aiding and abetting liability.[183]

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[178] Allan Sloan, *Laying Enron to Rest*, NEWSWEEK, June 5, 2006, at 25.

[179] S. REP. NO. 104-98, at 16 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 695.

[180] *Id.* at 5 ("The mere specter of 10b–5 liability, however, has become more than a deterrent to fraud. Private securities class actions under 10b–5 inhibit free and open communication among management, analysts, and investors. This has caused corporate management to refrain from providing shareholders forward-looking information about companies."); *Id.* at 9 ("Many companies refuse to talk or write about future business plans, knowing that projections that fail to materialize will inevitably result in a lawsuit.").

[181] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 189 (1994).

[182] *Id.* ("[N]ewer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional . . . .").

[183] Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 772 (2008) (noting that the potential uncertainty surrounding aiding and abetting liability could raise the cost of business and deter overseas firms from doing business in the United States).

These same concerns are implicated—perhaps even intensified—by the potential of criminal aiding and abetting liability. Securities professionals may fear that, if a company to whom they have provided services were to fail, they would be at risk of criminal liability. This apprehension may deter professionals from providing services to emerging companies or may compel them to charge prohibitively high prices, both with the effect of stifling the economy. In addition, secondary actors may feel compelled, beyond their ordinary duties, to "monitor public statements made by others, thus straining the economy."[184]

### *F. The Breadth of Conduct Within the Scope of the Criminal Laws May Afford Prosecutors Undue Discretion.*

The criminalization of conduct outside the scope of the civil securities laws, such as the making of false statements that are either objectively immaterial or forward-looking, affords prosecutors broad discretion to decide whether to prosecute a corporate executive. Every corporate executive who makes an optimistic statement or rosy prediction is potentially subject to prosecution if the company's stock later takes a downward turn. The virtual unavailability of pretrial motion practice to weed out unmeritorious claims strengthens the prosecutor's power to prosecute borderline conduct. This broad prosecutorial discretion has several ramifications.

First, the strategy of overcriminalizing conduct and allowing prosecutors to choose who is "deserving" of prosecution is an uninspiring rationale for criminal liability.[185] When two actors in the same position are treated differently—one vilified as a criminal and the other permitted to remain in society—it undermines society's justification for imprisonment.[186]

Second, the separation of powers doctrine is implicated when Congress enacts such broad statutes that it essentially abdicates its legislative role, allowing prosecutors and the courts to decide what

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[184] Brief Amicus Curiae for Defense Research Institute in Support of Respondents at 2, *Stoneridge*, 128 S. Ct. 761 (2008) (No. 06-43), 2007 WL 2329636.

[185] Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23, 60 (1997) ("'Criminalize them all and let prosecutors sort them out' is not a particularly inspiring slogan for a penal code.").

[186] Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 424 (1958) (rejecting as an "arrogant assertion" the idea that "it is proper to visit the moral condemnation of the community upon one of its members on the basis solely of the private judgment of his prosecutors").

conduct to criminalize. The separation of powers limits judicial review of prosecutors' discretion.[187] By the same token, however, the separation of powers also limits prosecutors' ability to usurp the legislature. When Congress overcriminalizes, prosecutors appropriate Congress's law-making functions. The executive branch decides which conduct to prosecute and which to ignore—without any of the public hearings, vigorous debate, or democratic process of the legislative branch.[188] For example, likely because of the breadth of the mail and wire fraud statutes, the DOJ has an official prosecution policy to avoid prosecuting schemes that "consist[] of some isolated transactions between individuals, involving minor loss to the victims" and to focus on "any scheme which in its nature is directed to defrauding a class of persons, or the general public, with a substantial pattern of conduct."[189] To the extent that courts are asked to decide whether conduct is within the scope of a broad, vague statute, the judicial branch—also without the hallmarks of the legislative process—performs legislative functions.[190]

Finally, this broad discretion allows prosecutors to make prosecution decisions based on improper factors such as "race, class, or ethnicity."[191] Moreover, especially relevant in the white collar

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[187] United States v. Armstrong, 517 U.S. 456, 464 (1996) (characterizing the decision to prosecute as "a 'special province' of the Executive" (quoting Heckler v. Chaney, 470 U.S. 821, 832 (1985))); Wayte v. United States, 470 U.S. 598, 607 (1985) ("[T]he decision to prosecute is particularly ill-suited to judicial review."); Eric Biber, *The Importance of Resource Allocation in Administrative Law*, 60 ADMIN. L. REV. 1, 19 (2008) ("The Supreme Court has repeatedly held that prosecutors' decisions as to whether or not to file criminal charges are generally unreviewable by the courts."); Angela J. Davis, *The American Prosecutor: Power, Discretion, and Misconduct*, 23 CRIM. JUST. 24, 28 (2008) ("Courts have consistently deferred to the expertise of prosecutors in declining to question their motives for charging and other important prosecutorial decisions.").

[188] Geraldine Szott Moohr, *Mail Fraud and the Intangible Rights Doctrine: Someone to Watch Over Us*, 31 HARV. J. ON LEGIS. 153, 179 (1994) ("When prosecutors select cases according to their own agendas of social control, bureaucratic necessity, or personal advancement, lawmaking devolves to law enforcers."); Michael P. Murphy, Note, *"Of" as a Loaded Word: Congress Tests the Boundaries of Its Commerce Power with an Amendment to the Federal Murder-for-Hire Statute*, 13 WM. & MARY BILL RTS. J. 1375, 1398 (2005) ("Congressional abnegation of its authority to dictate the criminal law menu by establishing a generous buffet of criminal law from which federal prosecutors may freely choose threatens the system of checks and balances by effectively transferring power to establish priorities in criminal law to the executive branch.").

[189] *See* U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL § 9-43.100 (1997).

[190] Kolender v. Lawson, 461 U.S. 352, 358 n.7 (1983) ("'It would certainly be dangerous if the legislature could set a net large enough to catch all possible offenders, and leave it to the courts to step inside and say who could be rightfully detained, and who should be set at large. This would, to some extent, substitute the judicial for the legislative department of government.'" (quoting United States v. Reese, 92 U.S. 214, 221 (1876))).

[191] Erik Luna, *The Overcriminalization Phenomenon*, 54 AM. U. L. REV. 703, 726 (2005).

crime context, broad prosecutorial discretion allows the executive branch to prosecute defendants in response to political pressure and public outcry. For example, during the Congressional hearings on the Enron collapse and bankruptcy, the company's top executives were called, variously, "the most accomplished confidence man since Charles Ponzi,"[192] "a carnival barker,"[193] and an "economic terrorist[]."[194] In this atmosphere, the Enron Task Force faced "pressure to deliver"[195] and eventually succeeded in indicting thirty-four defendants.[196]

### *G. The Criminalization of Conduct Not Civilly Actionable Affords the SEC Remarkable Leverage in Negotiating Civil Settlements.*

SEC enforcement actions forge a middle ground between the breadth of criminal liability and the narrowness of private civil liability. As in a criminal case, the safe harbor for forward-looking statement is unavailable in SEC enforcement proceedings, the SEC may pursue aider and abettors in addition to primary violators, and the stringent pleading requirements of the PSLRA do not apply.[197] As in a private civil action, however, the wire/mail fraud run-around is unavailable to the SEC because the SEC institutes only civil proceedings, and defendants can draw on the civil tradition of filing motions to dismiss.[198] In sum, the gap between criminal liability and SEC enforcement liability is smaller than the gap between criminal liability and private civil liability, but the gap nonetheless exists.

The breadth of potential criminal liability increases the pressure on a defendant under SEC investigation to reach a settlement with the SEC, even if the defendant has strong defenses to liability. The SEC is explicitly authorized to refer matters to the DOJ for

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[192] *Collapse of Enron: Hearing Before the S. Comm. on Commerce, Sci. and Transp.*, 107th Cong. 4 (2002) (statement of Sen. Peter Fitzgerald), *available at* 2002 WL 219196.

[193] *Id.*

[194] *The Financial Collapse of Enron—Part 2: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Energy and Commerce*, 107th Cong. 16 (2002) (statement of Rep. Bobby L. Rush), *available at* 2002 WL 193684.

[195] Edward Iwata, *Enron Task Force Faces Big Pressure to Deliver*, USA TODAY, Aug. 21, 2002, at 1B, *available at* 2002 WLNR 4499099.

[196] *The Fall of Enron: Prosecution Scorecard*, CHRON.COM, http://www.chron.com/news/specials/enron/ (last visited Dec. 2, 2008) (showing thirty-four criminal defendants).

[197] *See* 15 U.S.C. § 78u-5(c) (2006); 17 C.F.R. § 202.5(b) (2008).

[198] *See* 15 U.S.C. § 78u-4(b)(3)(A) (2006).

prosecution[199] and to transmit evidence that it has gathered to the DOJ.[200] As a result, the SEC and the DOJ routinely work together on investigations,[201] and the prospect of criminal indictment is often used as leverage to convince a defendant to agree to a settlement.[202] This "good cop/bad cop" tactic is extremely effective in achieving cooperation from the defendant. The threat, implicit or explicit, of criminal indictment, coupled with the reality that it is in many ways easier to criminally convict a defendant than to hold him civilly liable in an enforcement action, can render settlement with the SEC irresistible, even in cases where the SEC is overreaching.

### *H. The Narrow Scope of Private Civil Liability Leaves Injured Investors Uncompensated.*

As a consequence of the narrow scope of private civil liability, investors who are injured by criminally actionable conduct are often uncompensated. For example, the following investors are generally without civil remedy: (1) investors who make investment decisions based on false, but objectively immaterial, statements;[203] (2) investors who make investment decisions based on false forward-looking statements that are accompanied by meaningful cautionary

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[199] 17 C.F.R. § 202.5(b) (2008).

[200] 15 U.S.C. § 77t(b) (2006); 15 U.S.C. § 78u(d) (2006); David H. Kistenbroker, Pamela G. Smith, David S. Slovick & Alyx S. Pattison, *Criminal and Civil Investigations:* United States v. Stein *and Related Issues, in* SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2006 483, 504 (Practising Law Institute 2006) (noting that "the United States Attorney may reap the rewards of the SEC's labor by building a criminal case based almost entirely on the fruits of the SEC's civil investigation").

[201] In fact, the Ninth Circuit recently held that, as long as the SEC has generally warned a defendant that information received in the course of an investigation might be shared with the DOJ and has not affirmatively stated that it is not sharing information with the DOJ, the SEC may funnel the gathered evidence to the DOJ during the investigation without informing the defendant. United States v. Stringer, 535 F.3d 929, 938, 940–41 (9th Cir. 2008).

[202] Geraldine Szott Moohr, *What the Martha Stewart Case Tells Us About White Collar Criminal Law*, 43 HOUS. L. REV. 591, 601 (2006) ("[T]he threat of criminal charges obviously strengthens the government's position in negotiations over the civil matter."); Mary Jo White, *The Current Enforcement Environment: The Best of Times/The Worst of Times—Can We Reach A Reasonable Middle Ground?, in* 2 36TH ANNUAL INSTITUTE ON SECURITIES REGULATION 997, 1008 (Practising Law Institute 2004) ("[C]ompanies feel tremendous pressure to settle with the SEC or Attorney General on the civil side on terms they consider far beyond fair in order to lift the crushing weight and adverse publicity of long-running parallel civil and criminal investigations, as well as the threat of a company-threatening indictment."); Christian Babich, Comment, *Parallel Proceedings: The Government's Double-Team Approach and the Degradation of Constitutional Protections*, 11 LEWIS & CLARK L. REV. 753, 754 (2007) ("It has become common practice in corporate fraud investigations for the SEC to induce 'full cooperation' by implicitly or explicitly promising to mitigate civil and criminal liability.").

[203] *See supra* text accompanying notes 9–31.

language;[204] (3) investors defrauded by insolvent primary violators;[205] and (4) defrauded investors who are unable to plead their case with the requisite specificity without the benefit of discovery.[206]

The possibility that the SEC might distribute to injured investors disgorgement and penalties that it has collected, although not "toothless,"[207] is of little comfort to injured investors. The receipt of any compensation depends on numerous factors, including—most importantly—whether the SEC decides to pursue an enforcement action.[208]

The compensation of injured investors is not, however, a central goal of the securities acts, and the absence of compensation for certain investors does not necessarily impede the purposes of the securities acts. The securities acts were enacted to "insure the maintenance of fair and honest markets"[209] and "to protect investors."[210] In order to accomplish these goals, the acts promote "full disclosure of information thought necessary to informed investment decisions."[211] Full disclosure is mandated by the acts, and the enforcement mechanisms ensure compliance with the acts' mandates.

Consistent with these goals, the implied private right of action for securities fraud is primarily useful as a tool for deterrence. Together with the acts' other enforcement mechanisms, it ensures compliance with the acts' mandates. The private right of action has a side benefit of compensating investors, but that is not its central purpose. For example, Senators Paul Sarbanes, Barbara Boxer, and Richard Bryan, who strongly support the extension of private civil liability to aiders and abettors, crafted their argument in terms of its deterrence value, not its potential for compensating investors:

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[204] *See supra* text accompanying notes 49–61.

[205] *See supra* text accompanying notes 62–73.

[206] *See supra* text accompanying notes 101–07.

[207] Stoneridge Inv. Partners, L.L.C v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 773 (2008).

[208] *See* 15 U.S.C. § 7246 (2006) (creating a "fair fund[] for investors").

[209] 15 U.S.C. § 78b (2006).

[210] 15 U.S.C. § 77b(b) (2006); SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

[211] *Ralston Purina Co.*, 346 U.S. at 124; *see also* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 171 (1994) ("Together, the Acts 'embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor.'" (emphasis omitted) (quoting Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972))); S. REP. NO. 104-98, at 4 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 683 ("During the Great Depression, Congress enacted the 1933 and 1934 Acts to promote investor confidence in the United States securities markets and thereby to encourage the investment necessary for capital formation, economic growth, and job creation.").

"[T]he deterrent effect of the securities laws would be strengthened if aiding and abetting liability were restored in private actions as well."[212] Similarly, when recently reiterating that private civil liability extends only to primary violators, the Supreme Court emphasized the strong deterrent effect of SEC enforcement and criminal liability.[213]

Therefore, as recognized by the Supreme Court in *Central Bank*, it would not necessarily follow from an expansion of private civil liability to compensate additional injured investors that "the objectives of the statute [would be] better served."[214] If the potential of criminal liability and SEC enforcement were sufficient to ensure compliance with the acts' mandates,[215] the expansion of the private right of action would not necessarily advance the statutes' objectives and, in fact, might hinder those objectives by stifling "efficiency, competition, and capital formation."[216]

## IV. THEORIES ABOUT THE CIVIL-CRIMINAL DIVIDE EXPLAIN SOME COMPONENTS OF THE DIFFERING CIVIL AND CRIMINAL TREATMENT OF CONDUCT SOUNDING IN SECURITIES FRAUD.

In addition to disrupting the current scheme of securities regulation, the anomaly of criminalizing conduct that sounds in securities fraud but is not civilly actionable undercuts an assumption underlying current scholarship on the civil-criminal divide. The two leading theories about the civil-criminal divide—one based on an economic analysis of the law and the other based on moral considerations—assume that criminal liability is a subset of civil liability in circumstances in which the relevant conduct has identifiable individual victims. Applying the reasoning underlying these theories to conduct sounding in securities fraud, however, explains some aspects of the differing civil and criminal treatment of this unique conduct.

### *A. The Current Scholarship on the Civil-Criminal Divide Assumes*

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[212] SEN. REP. NO. 104-98, at 49 (Additional Views of Senators Sarbanes, Boxer, and Bryan, included with S. REP. NO. 104-98, at 36–50).

[213] Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc. 128 S. Ct. 761, 773 (2008).

[214] *Central Bank*, 511 U.S. at 188.

[215] Of course, whether the potential of criminal liability and SEC enforcement are, in fact, sufficient deterrence is a separate issue.

[216] 15 U.S.C. § 77b(b) (2006) (instructing the SEC, when it is engaged in rulemaking, to consider the protection of investors and "whether the action will promote efficiency, competition, and capital formation").

*That Civil Liability Is More Expansive than Criminal Liability.*

As recognized by scholars on the civil-criminal divide, including Kenneth G. Dau-Schmidt,[217] Richard A. Posner,[218] Steven Shavell,[219] John Coffee,[220] Stephen Marks,[221] and Paul H. Robinson,[222] criminal liability is ordinarily a subset of civil liability in instances where the relevant conduct injures identifiable individuals. Some civilly actionable conduct is so wrongful that it is also a crime. If criminal conduct involves a mens rea and an identifiable victim, the conduct is usually also civilly actionable. This relationship between civil and criminal liability is supported by the general rationale that criminal sanctions are more severe than civil liability. In other words, "conviction for crime is a distinctive and serious matter—a something, and not a nothing."[223] For this reason, criminal liability

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[217] Dau-Schmidt, *supra* note 152, at 23 & n.108 ("[A]lmost all crimes are also torts. . . . The most common exception is crimes that are merely malum prohibitum and crimes, such as attempts, in which there is no actual harm." (emphasis omitted)).

[218] Posner, *supra* note 131, at 1199 ("All of the pure coercive transfers that I have discussed are intentional torts at common law; and the subset of intentional torts that consists of pure coercive transfers (not all intentional torts are such) represents the largest category of criminal acts.").

[219] Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1240 (1985) ("There are, of course, several areas other than that of unintentional torts where monetary sanctions but not imprisonment are employed: intentional torts either that cannot be punished under the criminal law, such as defamation, or that the state often decides not to prosecute criminally, such as assault and battery; and acts punished by fines only, including many violations of tax, business, and driving regulations.").

[220] John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875, 1887 (1992) [hereinafter Coffee, *Paradigms*] ("The overall structure this relationship points toward is a penumbra of civil penalties around an inner core of fundamental moral precepts enforced by sanctions."); John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 199 (1991) [hereinafter Coffee, *Unlawful*] ("[T]he criminal law seems much closer to being used interchangeably with civil remedies. Sometimes, identically phrased statutes are applicable to the same conduct—one authorizing civil penalties, the other authorizing criminal sanctions. More often, the criminal law is extended to reach behavior previously thought only civilly actionable." (footnote omitted)); *Id.* at 201 ("The relationship of the civil and criminal law here is sequentially interactive: the civil law experiments with a standard, but at some point it may 'harden' into a community standard that the criminal law can enforce.").

[221] Stephen Marks, *Utility and Community: Musings on the Tort/Crime Distinction*, 76 B.U. L. REV. 215, 233 (1996) (positing that tort law encompasses both prohibited and conditionally permissible acts and that criminal law encompasses only prohibited acts, thus implying that criminal law is a subset of tort law).

[222] Paul H. Robinson, *The Criminal-Civil Distinction and the Utility of Desert*, 76 B.U. L. REV. 201, 210 (1996) ("Civil law has taken on some characteristics of criminal law, such as its increased use of punitive damages, but more commonly criminal law has been expanded to include what were traditionally civil violations." (footnote omitted)).

[223] Hart, *supra* note 186, at 404.

is more limited in scope than civil liability, and criminal defendants are afforded more procedural safeguards than civil defendants.[224]

The possibility that criminal liability could be more expansive than civil liability has been virtually ignored by the scholars, although Gerald E. Lynch has, in passing, noted this anomaly in the context of RICO:

> There is a distinct oddity here, from the standpoint of traditional distinctions between criminal and civil law: Historically, we have expected the criminal law to be narrower and more precise than the law of civil wrongs, but in interpreting RICO, the courts have been distinctly more comfortable with broad interpretations in criminal cases, and correspondingly more hostile to civil applications.[225]

This "distinct oddity" in the context of conduct sounding in securities fraud suggests two initial conclusions about its causes and effects.

First, the differing civil and criminal treatment arguably balances two competing congressional concerns: appeasement of the public and protection of big business. Criminal prosecution of corporate executives for fraud permits injured shareholders to feel vindicated.[226] At the same time, the unavailability of civil remedies for this same conduct shields corporations from monetary losses.[227]

Second, the anomalous civil and criminal treatment of conduct sounding in securities fraud suggests that corporate defendants are being overpunished and overdeterred or that civil securities

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[224] Aaron Xavier Fellmeth, *Civil and Criminal Sanctions in the Constitution and Courts*, 94 GEO. L.J. 1, 7–8 (2005) ("That the Framers of the Constitution and Bill of Rights incorporated these protections indicates their belief that society holds a unique interest in limiting the state's power to stigmatize and punish and, to this end, that criminal procedures should guarantee protections transcending those offered to citizens subjected to civil suit or regulation."); Hart, *supra* note 186, at 404 & n.12 (detailing the constitutional protections afforded criminal defendants).

[225] Lynch, *supra* note 185, at 29.

[226] *See* Recine, *supra* note 7, at 1544–45 (compiling sources reporting public outrage and widespread calls for criminal prosecution after the collapses of WorldCom and Enron); *All Things Considered: Hometown Residents React to Ebbers Verdict* (NPR radio broadcast March 16, 2005), *available at* http://www.npr.org/templates/story/story.php?storyId=4537936 (reporting that many citizens of Bernard Ebbers' hometown, some of whom lost money investing in WorldCom, welcomed his guilty verdict); *Enron Verdicts Bring Closure To Scandal's Victims* (CBS 2 Chicago broadcast May 25, 2006) *available at* http://cbs2chicago.com/topstroies/Enron.Ken.Lay.2.328537.html (reporting that former employees who lost money in Enron stock felt happiness about the conviction of Enron founder Ken Lay and former CEO Jeffrey Skilling).

[227] S. REP. NO. 104-98, at 9 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 688 (characterizing securities fraud class actions as having "an in terrorem effect on Corporate America").

plaintiffs are being under-compensated. As a companion to the general assumption that criminal law is a subset of civil law, scholars typically agree that the criminal law punishes and deters and that the civil law compensates.[228] Ordinarily, therefore, if a person's conduct is worthy of punishment and deterrence, the harm caused by the conduct is civilly compensable. This relationship between punishment/deterrence and compensation is skewed in the securities context.

An examination of the reasoning underlying the leading theories of the civil-criminal divide, however, demonstrates that the causes and effects of the current scheme may be more nuanced than these two initial conclusions suggest. In fact, the anomalous civil and criminal treatment of conduct sounding in securities fraud is arguably consistent with some of the reasoning underlying the theories about the civil-criminal divide.

### *B. The Leading Theories About the Civil-Criminal Divide Shed Light on the Anomalous Civil and Criminal Treatment of Conduct Sounding in Securities Fraud.*

The scholarship on the civil-criminal divide falls into two general camps: those that use economics to explain the civil-criminal divide and those that explain the divide with moral principles.[229] Undoubtedly, there is some overlap between the two camps. For example, Professor Posner has noted that "on balance it would seem that adherence to generally accepted moral principles increases the wealth of society more than it reduces it,"[230] and Alvin K. Klevorick has argued that an economic view of society presupposes a transaction structure formed by values.[231] This overlap does not,

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228 Coffee, *Unlawful, supra* note 220, at 231 ("[T]ort law and criminal law are institutionally segregated so that one focuses principally on compensation and the other principally on deterrence."); Lynch, *supra* note 185, at 27 ("The traditional rough distinction between criminal and civil matters has been that criminal actions are brought by the sovereign to punish and deter violations of social norms, while civil actions are brought by private parties (or occasionally by the government in a proprietary or administrative capacity) to compensate those who have suffered damage or to prevent harms from occurring."); Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1808–09 (1992) (identifying the principal paradigmatic purpose of the criminal law as punishment and of the civil law as compensation for damage caused).

229 *See infra* text accompanying notes 233–274.

230 POSNER, *supra* note 152, at 261 (questioning "But how inconsistent are morality and efficiency?").

231 Alvin K. Klevorick, *Legal Theory and the Economic Analysis of Torts and Crimes*, 85 COLUM. L. REV. 905, 908 (1985) ("The law-and-economics explanation of the criminal sanction presupposes the existence of a transaction structure. . . . But explaining a particular society's

however, prevent the two theories from being useful analytic tools. Although the theories contain both normative and descriptive components,[232] for purposes of this article, the theories will be treated as descriptive. In other words, this article will examine whether either theory can explain the anomaly—not whether the anomaly is appropriate in light of either theory.

1. Economic Analysis of the Law Explains Some Components of the Differing Civil and Criminal Treatment of Conduct Sounding in Securities Fraud.

Economic analysis of the law purports to (1) identify what conduct is limited through the civil and criminal laws, and (2) explain when criminal liability is used, rather than civil liability, to limit that conduct. Applied in the context of securities fraud, economic analysis articulates why false statements to investors are limited by civil and criminal laws and may explain why criminal liability is broader than civil liability.

*a. Economic Analysis Explains Why False Statements to Investors Are Limited.*

Economic analysis of the law recognizes that the civil and criminal laws are used to achieve an optimal level of certain types of undesirable behavior. There are two general economic explanations of what behavior should be limited, both of which arguably apply to false statements to investors.

First, some proponents of an economic analysis of the law recognize that harm-causing behavior should be limited.[233] If conduct causes harm, the civil and criminal laws are used to limit that conduct to its optimal level, as determined through further economic analysis. Under this view, false statements to investors

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transaction structure requires an understanding of societal values—a conception of how a society legitimates its transaction structure.").

[232] POSNER, *supra* note 152, at 25 ("[P]rovided that efficiency is any sort of value in our ethical system, two normative uses of economics mentioned earlier—to clarify value conflicts and to point the way toward reaching given social ends by the most efficient path—are untouched by the philosophical debate.").

[233] MODEL PENAL CODE § 1.02(a) (1962) (stating that one of "[t]he general purposes of the provisions governing the definition of offenses" is "to forbid and prevent conduct that unjustifiable and inexcusably inflicts or threatens substantial harm to individual or public interests"); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 172 (1968) ("Usually a belief that other members of society are harmed is the motivation behind outlawing or otherwise restricting an activity.").

are limited because they cause harm to investors.

Other proponents of an economic analysis of the law characterize the conduct to be limited as the "bypassing of market transactions."[234] In other words, if an actor coerces a transfer, rather than engaging in a voluntary market exchange, the actor's behavior should be limited to its optimal level by the civil and criminal laws. As explained by Professor Posner, the victim of the coercive transfer need not be the person with whom the market transaction would have occurred:

> The role of the criminal law in discouraging market bypassing is obscured by the fact that the market transaction that the criminal bypasses is usually not a transaction with his victim. If someone steals my car, normally it is not because he wants that car and would have bought it from me if the criminal law had deterred him from stealing it. He steals to get money to use in buying goods and services from other people. The market transaction that he bypasses is the exchange of his labor for money in a lawful occupation. But it is still market bypassing.[235]

False statements to investors are arguably a market bypass. Individual perpetrators of securities fraud are generally motivated by job security and compensation.[236] Rather than achieving these goals through a market transaction—namely, by achieving favorable results—the perpetrators bypass the market and make false statements. It is irrelevant that the victims of the market bypass—the investors—are not those with whom the market transaction would have occurred. Under this view, false statements to investors are limited because they bypass the markets.

*b. Economic Analysis Arguably Explains the Anomalous Civil and*

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[234] POSNER, *supra* note 152, at 208 ("These [intentional] torts and the corresponding list of crimes involve not a conflict between legitimate (productive) activities but a coerced transfer of wealth to the defendant in a setting of low transaction costs."); Posner, *supra* note 131, at 1195 ("The major function of criminal law in a capitalist society is to prevent people from bypassing the system of voluntary, compensated exchange—the 'market,' explicit or implicit—in situations where, because transaction costs are low, the market is a more efficient method of allocating resources than forced exchange.").

[235] Posner, *supra* note 131, at 1196 (emphasis omitted).

[236] John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1562–63 (2006) ("[S]ecurities fraud appears to be primarily motivated by the manager's own personal interests. Typically, managers hide bad news because they fear loss of their jobs (either from a dismissal or a hostile takeover), and they overstate favorable developments or inflate earnings in order to maximize the value of their stock options and other equity compensation.").

*Criminal Treatment of Conduct Sounding in Securities Fraud.*

Once the conduct to be limited is identified—either because it is harm-causing or market-bypassing—an economic analysis of the law determines how to limit the conduct to its optimal level, taking into account the costs and benefits to the actor and to society. Civil liability and criminal punishment are tools on a continuum to achieve this optimal level.

Proponents of an economic analysis of the law agree that criminal liability imposes a higher social cost than civil liability.[237] Unlike imprisonment—which imposes a hefty cost on the offender but does not compensate the victim—a transfer of money produces a gain to the victim equal to the cost to the offender.[238] Moreover, society's cost of imprisoning a person is far higher than the social cost of a transfer of money from the offender to the victim.[239] Gary S. Becker expressed the combination of these factors with the following formula for the total social cost of punishment: f=bf (where f=social cost of punishment; f=cost to offender of punishment; and b=coefficient that transforms f unto f.[240] Becker concluded that b equals approximately zero for fines (and, by extension, for civil liability), while b is greater than one for imprisonment.[241]

Under an economic analysis of the law, therefore, criminal liability is only optimal when the damages necessary to limit the offender's conduct to an optimal level are higher than the actor could pay.[242] In order to act as a deterrent, the amount of damages,

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[237] POSNER, *supra* note 152, at 222, 227 (stating that tort remedies are less costly than criminal fines and that criminal fines are less costly than imprisonment); Shavell, *supra* note 219, at 1235 ("The imposition of monetary sanctions will be assumed to involve lower social costs than the imposition of nonmonetary sanctions.").

[238] Becker, *supra* note 233, at 194 (recognizing that fines compensate victims, producing a gain to victim equal to cost to offender); Shavell, *supra* note 219, at 1235 ("The motivation for this assumption is that the disutility to parties who must make payments may be viewed as roughly balanced by the addition to utility of parties who receive the payments or, where fines are paid to the government, who find their tax burdens reduced. By contrast, the disutility experienced by parties punished by nonmonetary sanctions is not balanced in any automatic way by additions to the utility of other parties." (footnote omitted)).

[239] Becker, *supra* note 233, at 194 ("Not only do other punishments fail to compensate, but they also require 'victims' to spend additional resources in carrying out the punishment."); Shavell, *supra* note 219, at 1235 ("Furthermore, the imposition of nonmonetary sanctions often involves direct claims on goods and services, as with the building and operation of prisons.").

[240] Becker, *supra* note 233, at 180.

[241] *Id.*

[242] *See id.* at 181 (explaining that the goal is to determine a combination of the various components of social cost that minimizes the total sum of social loss); Posner, *supra* note 131, at 1201, 1203 (explaining that total social loss is a function of the following factors: the

when multiplied by the probability of liability, must be higher than the probability of success multiplied by the expected gain.[243] In addition, the amount of monetary liability must be within the defendant's ability to pay.[244] Once the ceiling of the actor's ability to pay is surpassed, additional monetary liability does not increase the level of deterrence and criminalization is necessary.[245]

In the context of securities fraud, criminalization is arguably necessary to achieve an optimal level of conduct. At first glance, the imposition of criminal liability might appear to be unnecessary because white collar defendants often possess the ability to pay large sums of money.[246] The practical reality, however, is that individual defendants seldom pay the damages imposed by civil securities fraud liability. Rather, these costs fall largely on the corporation and its insurer.[247] The expenses incurred by the corporation are ultimately borne by its shareholders.[248] As a result, the probability that an individual defendant would be required to pay monetary damages for his conduct is so low that the amount of potential damages required to achieve the optimal level of deterrence is often beyond even the wealthiest defendant's reach. The imposition of criminal liability for securities fraud is therefore arguably explained by an economic analysis of the law.

In addition, an economic analysis of the law may explain why, in

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benefit to the actor, the harm to society from the action, the probability of holding the actor accountable, the cost of apprehending and holding the actor accountable, the cost to the actor of accountability, and the cost to society of accountability).

[243] Posner, *supra* note 131, at 1201–03 (explaining that the damages necessary to discourage bypassing the market must make the actor more than indifferent to the bypass).

[244] POSNER, *supra* note 152, at 222 ("[T]he optimal damages will often be very great—greater, in many cases, than the tortfeasor's ability to pay.").

[245] *See id.* ("Where tort remedies are an adequate deterrent because optimal tort damages, including any punitive damages, are within the ability to pay of the potential defendant, there is no need to invoke criminal penalties . . . .").

[246] *Id.* at 228 (questioning the justification for imprisoning defendants who could afford to pay fines).

[247] Coffee, *supra* note 236, at 1550 ("Although [corporate insiders] are regularly sued, they rarely appear to contribute to the settlement. Rather, the corporate defendant and its insurer typically advance the entire settlement amount.").

[248] *Id.* at 1536 ("[B]ecause the costs of securities class actions—both the settlement payments and the litigation expenses of both sides—fall largely on the defendant corporation, its shareholders ultimately bear these costs indirectly and often inequitably."); Anjan V. Thakor, The Unintended Consequences of Securities Litigation, 8–9 (October 2005) (unpublished research paper prepared for the U.S. Chamber Institute for Legal Reform), http://www.instituteforlegalreform.com/issues/docload.cfm?docId=857 ("[I]n securities litigation, the compensatory payments represent a transfer payment from previously 'undamaged' shareholders—those who held on to their securities through the alleged fraud period—to 'damaged' shareholders who acquired securities during the alleged fraud period.").

the context of securities fraud, civil liability is more limited than criminal liability. An assumption underlying an economic analysis of the law, as detailed above, is that criminal liability imposes a higher social cost than civil liability.[249] Under this assumption, it is logical that criminal liability would be imposed for a smaller swathe of conduct than civil liability. This assumption arguably does not hold true, however, in the unique context of securities fraud. Securities fraud lawsuits are unlike other civil lawsuits because the total social cost of civil liability far exceeds the actual dollar amount of the damages imposed.

The filing of a securities fraud lawsuit causes a steep drop in the value of the sued company's shares, in excess of the dip caused by the disclosure of the "truth" to the marketplace and the eventual transfer of wealth from the defendants to the victims.[250] In other words, the mere filing of the lawsuit causes equity to disappear; it is not a "zero-sum game."[251] This excessive loss of shareholder equity is attributable to financial distress costs (such as reduced access to credit) and a diminished ability to conduct business.[252]

In addition, the filing of a securities fraud lawsuit against one company has spillover effects on the securities markets and the overall economy. Securities fraud class actions decrease stock prices overall,[253] increase the costs of raising capital,[254] and chill corporate disclosure.[255] Overall lower stock prices, in turn, negatively affect capital investment, job creation, and business expansion.[256] In addition, the threat of expansive civil liability may

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249 *See supra* text accompanying notes 237–245.

250 Richard A. Bierschbach & Alex Stein, *Overenforcement*, 93 GEO. L.J. 1743, 1763–64 (2005) (recognizing that the "market spillover" from civil securities fraud actions includes severe drops in the value of the sued company's shares, generating "a threatening overenforcement potential along a number of dimensions"); Thakor, *supra* note 248, at 5 ("Thus, we can say that a *lower bound* estimate of the reduction in firm value solely due to [securities] litigation, as distinct from the effect of the disclosure of bad news, is about 3.5 [%].").

251 Thakor, *supra* note 248, at 6.

252 *Id.* at 6–8.

253 Coffee, *supra* note 236, at 1537 ("[S]tock prices generally rise when legislation is passed curtailing securities class actions.").

254 S. REP. NO. 104-98, at 9 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 688 (finding that securities fraud class actions "have added significantly to the cost of raising capital and represent a 'litigation tax' on business").

255 S. REP. NO. 104-98, at 4 (finding that securities fraud class actions "chill corporate disclosure").

256 *Id.* at 8 ("The Nation's capital markets play a critical role in our domestic economy by creating jobs and expanding businesses."); Thakor, *supra* note 248, at 14 ("Given that securities litigation lowers stock prices in and of itself, and lower stock prices induce firms to plan for lower capital investments, one can conclude that a potentially pernicious effect of

deter overseas companies from doing business in the United States and "shift[] securities offerings away from domestic capital markets."[257]

Finally, civil securities fraud class actions, with their voluminous pleadings and complicated motions to dismiss, consume considerable judicial resources, for which society foots the bill.[258] In fact, Professor Coffee has raised the question of "whether society is receiving an adequate return on its investment."[259]

In light of the spillover costs of a civil securities fraud lawsuit, above and beyond the mere transfer of a sum of money from the defendant to the victims, the total social cost of civil liability may be greater than the total social cost of criminal liability. Applying this proposition to Professor Becker's formula discussed above, in which b is the coefficient that transforms the cost of punishment to the offender into the social cost of punishment, b is arguably greater for civil liability than for criminal liability in securities cases.[260] In the unique context of securities fraud, therefore, it is arguably consistent with an economic analysis of the law for some conduct to be criminally, but not civilly, actionable.

2. Moral Analysis Explains Some Components of the Anomalous Civil and Criminal Treatment of Conduct Sounding in Securities Fraud.

Moral theories of the civil-criminal divide purport to (1) identify what conduct is classified as criminal and (2) articulate what goals are furthered through the imposition of criminal punishment. Applied in the context of securities fraud, moral analysis explains why false statements to investors are limited by criminal laws and highlights which goals are furthered, and which are hampered, by the anomalous civil and criminal treatment of conduct sounding in securities fraud.

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such litigation is to cause a decline in corporate capital investment and growth, although the precise magnitude of this is difficult to assess.").

257 Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 765 (2008).

258 Coffee, *supra* note 236, at 1540.

259 *Id.*

260 *See supra* text accompanying notes 240–41.

*a. Moral Analysis Explains Why False Statements to Investors Are Limited by the Criminal Laws.*

Under a moral theory of the civil-criminal divide, a crime is different from a tort because it incurs "a formal and solemn pronouncement of the moral condemnation of the community."[261] As a result, only conduct that is morally repugnant should be classified as a crime.[262] In other words, a crime is conduct for which society values no social utility, while a tort is conduct for which the actor's utility is acknowledged by society.[263] Although this formulation uses the economic term "utility," it relies on "other disciplines, including sociology, psychology, political science, philosophy, theology, criminology, and jurisprudence" to determine what activities have no societal value and should thus be designated as crimes.[264]

Making false statements to investors arguably implicates moral concerns to such a degree that it is worthy of criminal punishment under a moral analysis of the law. Prohibitions on lying come from sources as varied as the Ten Commandments[265] and Immanuel Kant.[266] Kant states, "To be truthful (honest) in all declarations is,

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[261] Hart, *supra* note 186, at 405; *see also* Luna, *supra* note 191, at 713–14 ("When society designates as 'crime' particular acts accompanied by a sufficient degree of subjective awareness or intent, it makes a critical moral judgment about the wrongfulness of such conduct, the resulting harm caused or threatened to others, and the culpability of the perpetrators.").

[262] MODEL PENAL CODE § 1.02(c) (1962) (stating that one of "[t]he general purposes of the provisions governing the definition of offenses" is "to safeguard conduct that is without fault from condemnation as criminal"); Coffee, *Unlawful*, *supra* note 220, at 225 (the criminal law "prefers to deal in moral absolutes"); Jerome Hall, *Interrelations of Criminal Law and Torts: II*, 43 COLUM. L. REV. 967, 996 (1943) ("[M]oral culpability should remain the essence of criminal liability . . . ."); Lynch, *supra* note 185, at 47 ("But if the dominant message of the criminal law is a moral one, the criminal law must remain a moral enterprise."); Alan C. Michaels, *"Rationales" of Criminal Law Then and Now: For a Judgmental Descriptivism*, 100 COLUM. L. REV. 54, 57 (2000) ("[T]he dominant view today sees an essential link between punishment and moral wrongdoing.").

[263] Coffee, *Paradigms*, *supra* note 220, at 1876 ("[C]riminal law should be reserved to prohibiting conduct that society believes lacks any social utility, while civil penalties should be used to deter (or 'price') many forms of misbehavior (for example, negligence) where the regulated activity has positive social utility but is imposing externalities on others."); Dau-Schmidt, *supra* note 152, at 23 (stating that when a tort is committed, society values the utility obtained from both sides of the incompatible preferences, but when a crime is committed, "there is a significant disparity in the value society assigns to the utility derived from each side of the incompatible preferences").

[264] Dau-Schmidt, *supra* note 152, at 37.

[265] *Exodus* 20:16 ("Thou shalt not bear false witness against thy neighbour.").

[266] IMMANUEL KANT, *On a Supposed Right to Lie because of Philanthropic Concerns*, *in* GROUNDING FOR THE METAPHYSICS OF MORALS WITH ON A SUPPOSED RIGHT TO LIE BECAUSE OF PHILANTHROPIC CONCERNS 63, 63 (James W. Ellington trans., Hackett Publ'g Co. 3d ed.

therefore, a sacred and unconditionally commanding law of reason that admits of no expediency whatsoever."[267]

*b. Moral Analysis May Explain the Anomalous Civil and Criminal Treatment of Conduct Sounding in Securities Fraud.*

Some theorists argue that criminal liability is reserved for a subset of conduct—that which is truly morally repugnant—because the imposition of criminal penalties is more costly to society than the imposition of civil liability.[268] Arguably, if civil liability were more costly to society than criminal liability, these theorists would support the imposition of civil liability on a subset of immoral conduct, leaving criminal liability for a wider swathe of conduct. As discussed above,[269] in the unique context of securities fraud, civil lawsuits may impose a higher social cost than criminal liability because of the various spillover effects—including lower stock prices, higher costs of raising capital, chilled corporate disclosure, and consumption of judicial resources. This reasoning may explain the breadth of criminal liability compared to the narrowness of civil liability for conduct sounding in securities fraud.

*c. Moral Analysis Explains What Goals Are Furthered by the Differing Civil and Criminal Treatment of Conduct Sounding in Securities Fraud.*

Several theories explain the imposition of liability for morally repugnant conduct: corrective justice, retributive justice, and compensatory justice. Traditionally, scholars discussed the goals of liability separately in the contexts of tort and crime, but, as noted by Gary T. Schwartz, parallel theories developed in each context, permitting a merged analysis of the goals of tort and criminal liability.[270] These theories support some components of the

Supp. 1993) (1785) (rejecting the proposition that there ever exists either the right or the duty to be untruthful, even when asked by a murderer the whereabouts of his intended victim).

[267] *Id.* at 65.

[268] Coffee, *Paradigms*, *supra* note 220, at 1877 ("[T]he criminal law's scope must be limited because society's capacity to focus censure and blame is among its scarcest resources."); Dau-Schmidt, *supra* note 152, at 35.

[269] *See supra* text accompanying notes 246–60.

[270] Gary T. Schwartz, *Mixed Theories of Tort Law: Affirming Both Deterrence and Corrective Justice*, 75 TEX. L. REV. 1801, 1801 (1997) (recognizing the "two major camps of tort scholars" as embracing the tort goals of deterrence and corrective justice, and comparing them to the two major camps of criminal scholars who embrace the goals of deterrence and retribution); *Id.* at 1833–34 ("The discussions within criminal law scholarship of the goals of

anomalous civil and criminal treatment of conduct sounding in securities fraud.

Under a corrective justice theory, liability should have three components: (1) imposition of liability for immoral behavior;[271] (2) compensation of victims; and (3) financing of the compensation by the responsible party.[272] Under the current scheme of civil and criminal liability, only one of these elements is satisfied when an actor lies to investors about objectively immaterial matters, makes false forward-looking statements to investors, or aids and abets a perpetrator of securities fraud. This conduct is punished criminally, thus satisfying the first component, but is not civilly actionable, thus failing to satisfy the second and third components. The anomalous treatment of conduct sounding in securities fraud is not consistent with a corrective theory of justice.

Retributive justice focuses on punishing a blameworthy individual for immoral behavior, rather than on compensating the victims.[273] The imposition of criminal but not civil liability on corporate executives for making false statements to investors or for aiding and abetting securities fraud is consistent with the retributive theory of justice because the executives are punished. The failure of the victims to be compensated is irrelevant under this theory.

Finally, compensatory justice focuses—not on punishing the

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deterrence and retributive justice in many ways parallel the debate among tort scholars as to the goals of deterrence and corrective justice.").

[271] Susan Randall, *Corrective Justice and the Torts Process*, 27 IND. L. REV. 1, 7 (1993) (documenting that corrective justice theorists "posit a moral basis" for liability).

[272] Christopher H. Schroeder, *Corrective Justice and Liability for Increasing Risks*, 37 UCLA L. REV. 439, 449–50 (1990) ("These three components . . . . sanction defendants in accordance with their moral responsibility and they compensate plaintiffs to the degree they have been wrongfully injured, all in accordance with the demands of moral autonomy."); Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 332 (1990) ("[T]he tort defendant, having created risks in a certain way, should serve as the actual source of the compensation payment."); Richard W. Wright, *Substantive Corrective Justice*, 77 IOWA L. REV. 625, 704 (1992) ("The party whose goods are adversely affected by the behavior of another that is inconsistent with the parties' absolute moral equality has a claim to rectification. The only person to whom such a claim can be directed is the other party to the interaction, who caused the adverse effect through such behavior.").

[273] Michele Cotton, *Back with a Vengeance: The Resilience of Retribution as an Articulated Purpose of Criminal Punishment*, 37 AM. CRIM. L. REV. 1313, 1317 (2000) ("Retribution, on the other hand, assumes that the criminal should be hurt, and that the injury caused by the criminal offense calls for a like infliction of injury on the criminal as a moral penalty."); David Dolinko, *Three Mistakes of Retributivism*, 39 UCLA L. Rev. 1623, 1627 (1992) ("The notion that the criminal's *deserving* punishment is sufficient to justify inflicting it on him is central to most versions of retributivism, historical and contemporary."); Schwartz, *supra* note 272, at 326 ("Such an argument stipulates that a defendant, because he has acted in a certain improper way, should be required to bear the burden of liability for the resulting harm.").

defendant—but on compensating the victims.[274] Under this theory, it is not necessary that the morally responsible actor compensate the victims, so long as the victims are compensated by someone. In the context of securities fraud, this theory does not explain why certain immoral conduct would be punished criminally but not civilly. When the conduct is punished only criminally, the victims are not compensated.

## V. CONCLUSION

In conclusion, substantive and procedural differences between criminal and civil treatment of conduct sounding in securities fraud cause criminal liability to exceed the scope of private civil liability. The potential repercussions of this anomaly are far-reaching, including chilling corporate disclosure, creating a class of reasonable investors who make investment decisions on the basis of vague statements of corporate optimism, transferring enforcement responsibility away from the SEC to the DOJ and the individual states, discouraging professionals from advising emerging companies, affording prosecutors undue discretion in deciding what conduct to prosecute, coercing defendants into agreeing to unfavorable settlements with the SEC, and leaving injured investors without compensation.

The rationales underlying the theories about the civil-criminal divide explain some components of the anomalous criminal and civil treatment of conduct sounding in securities fraud. Under an economic analysis of the law, the immense social cost imposed by civil liability—arguably exceeding the social cost imposed by criminal liability—may explain why civil liability is more limited than criminal liability in this unique context. Under a moral view of the civil-criminal divide, the imposition of criminal liability, even without companion civil liability, satisfies the goal shared by corrective and retributive justice theories of holding the morally responsible actor liable. The absence of civil liability for some conduct that violates moral lines, however, is contrary to the goal shared by corrective and compensatory justice theories of compensating the victims.

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[274] Schwartz, *supra* note 272, at 328 ("The essence of such an argument is that the defendant—having been involved in a certain way in the infliction of the plaintiff's injury—is under an obligation to make sure that the plaintiff receives compensation for that injury." (footnote omitted)).

Therefore, this article proposes a two-step solution. First, in light of the far-reaching effects of the anomalous civil and criminal treatment of conduct sounding in securities fraud and the failure of the theories about the civil-criminal divide to explain the anomaly fully, Congress should reign in the scope of criminal liability to the current reach of civil liability by curtailing the use of the wire/mail fraud run-around, expanding the safe harbor for forward-looking statements to criminal actions, imposing stricter pleading standards for criminal indictments, and preempting broad state criminal laws.

Second, because the more expansive reach of criminal liability than civil liability is arguably consistent with many of the theories underlying the civil-criminal divide, Congress should consider carefully whether to expand the reach of criminal liability—while recognizing and compensating for the impacts of that expansion on the current scheme of securities regulation. For example, if Congress makes the deliberate decision to lower the materiality standard for criminal securities fraud, Congress should compensate for the chilling effect on voluntary disclosure by making more disclosures mandatory. Only by proceeding in a deliberate fashion can Congress simultaneously further the rationales underlying the civil-criminal divide and prevent the distortion of the carefully balanced scheme of securities regulation.