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By Wendy Gerwick Couture

I. Introduction

Securities fraud has been a federal crime since the enactment of the Securities and Exchange Act of 1934. Section 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder, prohibit securities fraud, and § 32(a) of the 1934 Act criminalizes the willful violation of "any provision of this chapter, or any rule or regulation thereunder," including § 10(b) and Rule 10b-5.

In 2002, in the wake of the collapses of WorldCom and Enron, Congress enacted the Sarbanes-Oxley Act. Section 807 of the Act, codified in 18 U.S.C. § 1348, created a new crime called "Securities fraud." Section 1348 defines this crime as follows:

Whoever knowingly executes, or attempts to execute, a scheme or artifice—

(1) to defraud any person in connection with . . . any security of [a reporting] issuer . . .; or

(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of . . . any security of [a reporting] issuer; shall be fined under this title, or imprisoned not more than 25 years, or both.

Section 1348 was slow to catch on. According to the Bureau of Justice Statistics, only 45 defendants were charged with violating §1348 from 2002 through 2010. By contrast, during this same period, 833 defendants were charged with violating § 10(b).

Recently, however, several courts have interpreted § 1348's elements as diverging from § 10(b) in several respects, leading to bar journal articles with titles like "Insider Trading Charges Under Section 1348-Without the 'Technical Elements?" and "The Evolving Mystery of Illegal Insider Trading."

Although these recent court decisions are sending shock waves through the legal community, the provision's author, Senator Patrick Leahy, was not bashful about his intention to create a new securities fraud crime that is easier to prove than § 10(b). In particular, Senator Leahy explained the new crime of securities fraud as follows:

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The provision would supplement the patchwork of existing technical securities law violations with a more general and less technical provision, with elements and intent requirements comparable to current bank fraud and health care fraud statutes . . . . The act[s]'s terms are not intended to encompass technical definition[s] in the securities laws, but rather are intended to provide a flexible tool to allow prosecutors to address the wide array of potential fraud and misconduct that can occur in companies that are publicly traded.10

This essay focuses solely on the materiality element of securities fraud—both in the misrepresentation and insider trading contexts. In Part II, this essay analyzes the materiality standard under § 1348 and concludes that it is probably lower than the materiality standard under § 10(b). In Part III, this essay considers the implications of this lower materiality standard in criminal securities fraud prosecutions under § 1348. Finally, Part IV briefly concludes with some advice for market participants, courts, and Congress.

II. Materiality Standards

A. Misrepresentation Context

This section analyzes whether the materiality of an alleged misrepresentation is defined differently under § 10(b) and under § 1348 and concludes that the definition of materiality under § 1348 likely includes a subjective component, unlike § 10(b)'s objective standard.

1. Section 10(b)'s Objective Materiality Standard

In misrepresentation cases under § 10(b) and Rule 10b-5(b),11 the materiality standard is objective, premised on the importance of the misstated or omitted fact to a “reasonable investor.” An alleged misrepresentation is material for purposes of securities fraud if there is “a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.”12 Stated differently, a statement is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in deciding how to invest.13

2. 18 U.S.C. § 1348's Subjective Materiality Standard

In misrepresentation cases under § 1348, the initial question is whether materiality is an element of the crime. If § 1348 had been enacted in a vacuum, there would be a colorable argument that conviction under § 1348(2) does not require a showing of materiality. Under Supreme Court precedent, a statute’s inclusion of the element of “fraud”—which has a well-settled meaning at common law—carries with it the presumption that Congress intended to incorporate materiality into the statute.14 On the other hand, if a statute permits conviction with merely a showing of “falsity,” there is no presumption that Congress intended to incorporate the element of materiality.
because "the term 'false statement' does not imply a materiality requirement." If the statute lists "false statement" and "fraudulent statement" in the alternative, there is no presumption that materiality is an element because conviction can be premised on mere falsity. Section 1348(2) does just this, allowing for conviction based on "false or fraudulent pretenses, representations, or promises." Therefore, arguably, conviction under § 1348(2) does not require a showing of materiality.

Section 1348 was not enacted in a vacuum, however. In fact, the text of § 1348 mirrors the text of 18 U.S.C.A. § 1344, which prohibits bank fraud. The bank fraud statute, in turn, was modeled on the mail and wire fraud statutes. Therefore, the caselaw construing the mail, wire, and bank fraud statutes should guide the interpretation of § 1348. In Neder v. United States, the Supreme Court—albeit without examining the grammar of the bank fraud statute in detail—held that the crimes of mail, wire, and bank fraud include the element of materiality. Therefore, Congress, by later choosing to enact identical language in § 1348, is presumed to have incorporated this settled interpretation of the statutory text. Moreover, the title of § 1348—which was enacted by Congress as positive law and which sheds light on proper interpretation of the section's text—labels the crime "securities fraud," confirming that Congress intended to incorporate the common law fraud element of materiality into the crime. Finally, to the extent there were any ambiguity, the rule of lenity would favor the narrower interpretation of this criminal statute, punishing only "material" misrepresentations under § 1348.

The next question is how materiality is defined under § 1348. In Neder, while holding that the mail, wire, and bank fraud statutes incorporate the common law element of materiality, the Supreme Court quoted with approval two definitions of materiality. First, the Court quoted the following definition from United States v. Gaudin: "In general, 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.' Second, the Court quoted the following Restatement (Second) of Torts definition of materiality:

(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 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.

Although a few courts have adopted the Restatement definition in subsequent mail and wire fraud cases, most courts apply the Gaudin
Both definitions differ markedly from the objective materiality definition used under § 10(b) because they include a subjective component. In particular, in the Gaudin definition, a statement is material if it is “capable of influencing,” even if it does not have a “natural tendency” to do so. Similarly, prong (b) of the Restatement definition allows for a finding of materiality, even if a reasonable person would not find the matter to be important.

Under current precedent, § 1348’s materiality element will likely be interpreted identically to the materiality element in the mail, wire, and bank fraud statutes. First, Congress’s mirroring of the bank fraud statute in § 1348 suggests—not only that Congress intended to incorporate a materiality element—but that Congress intended to interpret that element identically in both statutes. Second, the Supreme Court, drawing on common law precedent, has already interpreted identical text in the bank fraud statute as incorporating a subjective materiality element, and there is no indication that the Court would interpret the text in this provision differently.

The distinction between § 10(b)’s objective materiality standard and § 1348’s likely subjective materiality standard is best exemplified with an extreme hypothetical scenario. Imagine that, knowing that an investor relied on astrology to make stock picks, a CEO lied about his or her astrological sign in order to influence the investor’s investment decision. Under § 10(b), this misrepresentation would be immaterial as a matter of law because no reasonable investor would have found this information to be significant when making an investment decision. Under § 1348, on the other hand, a fact-finder could potentially find that this misrepresentation was material under the subjective materiality standard.

B. Insider Trading Context

This section analyzes whether the element of materiality is defined differently under § 10(b) and under § 1348 in the context of insider trading. This section concludes that several materiality standards potentially apply under § 1348, depending on the prosecution’s theory of insider trading, and that each standard likely differs from the § 10(b) standard.

1. Section 10(b)’s Investor-Oriented Materiality Standard

Insider trading liability is premised on a fraudulent failure to disclose. At common law, a failure to speak is only fraudulent if accompanied by a duty to speak. The Supreme Court has incorporated this common law limitation on fraudulent omissions into § 10(b). In particular, the Supreme Court has identified three circumstances in which a party owes a duty to disclose or abstain from trading. First,
the “classical theory” of insider trading applies to corporate insiders—such as officers and directors—and temporary insiders such as “an underwriter, accountant, lawyer, or consultant working for the corporation.” These insiders, who are in a fiduciary relationship with the company’s shareholders, must either disclose the inside information or abstain from trading in the company’s securities on the basis thereof. Second, the “misappropriation theory” of insider trading is implicated when a person “misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.” Under this theory, the relationship between the recipient and the source of the information gives rise to a duty on the part of the recipient either to abstain from trading on the information or to disclose his or her plans to trade to the source of the information. Finally, a “tippee” of an insider or a misappropriator is subject to §10(b)’s insider trading prohibitions if the tipper breaches a fiduciary duty by disclosing the information to the tippee and if the tippee knows or has reason to know that the disclosure is a breach. Whether the tipper’s disclosure constitutes a breach of fiduciary duty depends on whether the tipper “personally will benefit, directly or indirectly, from his disclosure.”

Section 10(b) currently imposes liability under the classical theory only if the inside information satisfies the investor-oriented objective materiality standard that applies in misrepresentation cases. In other words, under the classical theory, if a reasonable investor would not find the inside information to be significant in making an investment decision, trading on the basis of that information does not violate §10(b). The applicable definition of materiality under the misappropriation theory is less settled, with several courts and commentators musing that materiality should be linked to the source of the information. Most courts and commentators, however, apply the same investor-oriented materiality standard in all insider trading contexts, including cases premised on the misappropriation theory.

2. Section 1348’s Subjective and/or Source-Oriented Materiality Standards

This author has identified three distinct theories of insider trading liability under § 1348, each with its own materiality standard. None of these theories applies the objective, investor-oriented materiality standard that is ordinarily applied in insider trading cases under §10(b). As a consequence, the materiality standard is potentially lower in §1348 prosecutions than in prosecutions premised on violations of §10(b).

First, conduct that would fall within the classical, misappropriation, or tipping theories under §10(b)’s prohibition on “manipulative
or deceptive devices” would likely also fall within the scope of § 1348’s prohibition on “scheme[s] or artifice[s] to defraud.” The Supreme Court, when deriving these theories under § 10(b), relied on common law fraud jurisprudence, which also informs the Supreme Court’s interpretation of “scheme or artifice to defraud.” Moreover, the requisite nexus between the fraudulent conduct and securities is even more attenuated under § 1348, which merely requires a “connection with . . . any security of [a reporting] issuer,” than under § 10(b), which requires a “connection with the purchase or sale of any security.” The Neder subjective materiality standard probably applies to each of these familiar theories, however, rather than the § 10(b) objective standard. Therefore, it is possible that the same piece of inside information might be immaterial as a matter of law under § 10(b) but material under § 1348.

Second, just like the mail and wire fraud statutes, § 1348 prohibits schemes or artifices to obtain “property” by means of “false or fraudulent pretenses, representations, or promises.” In the mail and wire fraud context, the Supreme Court has interpreted the term “property” to include intangible property like “confidential business information.” Therefore, to the extent that a person is using “false or fraudulent pretenses, representations, or promises” to deprive the source of “its right to exclusive use of the information,” the conduct is potentially within the scope of § 1348. Under this theory, the element of materiality is source-oriented, rather than investor-oriented, because the source is the one duped by the “false or fraudulent pretenses, representations, or promises.” In other words, the materiality inquiry centers on whether the false pretense, representation, or promise that the person used in order to deprive the source of the exclusive use of the information was “material” to the source. For example, if a newspaper reporter, in violation of a promise of confidentiality, deprived the newspaper of its exclusive use of information about a forthcoming stock tip column by trading thereon, the materiality inquiry would center on whether the promise of confidentiality was material to the newspaper. This source-oriented materiality analysis is vastly different from the investor-oriented materiality analysis under § 10(b).

Third, § 1348’s prohibition on “scheme[s] or artifice[s] to defraud” includes honest services fraud. Section 1346 defines, for purposes of the chapter containing § 1348, the term “scheme or artifice to defraud” as including “a scheme or artifice to deprive another of the intangible right of honest services.” In Skilling v. United States, the Supreme Court interpreted honest services fraud as limited to bribery and kickback schemes. Under certain circumstances, an insider trading scheme might constitute a bribe or a kickback so as to fall within the
The scope of honest services fraud. For example, if an employee shares confidential information about his or her employer with a third party, in violation of the employee’s duties to the employer and in exchange for a share of the profits derived from trading, this is arguably akin to a bribe paid by the third party to the employee in order for the employee to violate his or her duties. The materiality standard that applies in the context of honest services fraud is whether the recipient of the duty of honest services—usually, the employer—would have tended to change its conduct if the employee had disclosed his or her secret dealings in violation of the duty. Therefore, like the intangible property fraud discussed above, the materiality analysis for honest services fraud is source-based, not investor-based.

The infamous squawk box case, United States v. Mahaffy, exemplifies the potential for prosecution under § 1348 for insider trading. In that case, the Government alleged that traders employed at several brokerage firms relayed information about institutional investors’ orders, which were transmitted on the firms’ squawk boxes, to employees of a day trading firm. In turn, as alleged, the day trading firm employees traded on the basis of this leaked information and compensated the leakers by executing wash trades that generated commissions for the leakers. Denying a motion to dismiss the indictment, the district court held that this alleged conduct could constitute a scheme or artifice to obtain the brokerage firms’ intangible property (namely, its confidential business information) in violation of § 1348. In addition, the district court held that this alleged conduct could constitute honest services fraud because the employees were alleged to have committed the fraud with the knowledge of the employees of their honest services, also in violation of § 1348. A jury ultimately convicted the defendant of conspiracy to commit honest services fraud and intangible property securities fraud under § 1348. On appeal, the Second Circuit vacated the intangible property securities fraud component of the conspiracy conviction because the Government committed Brady violations, and the Second Circuit vacated the honest services securities fraud component of the conspiracy conviction because the jury instructions did not adequately limit honest services fraud to bribery or kickback schemes, as required by the intervening decision in Shilling.

The Mahaffy case is especially noteworthy for purposes of this essay because the district court treated the element of materiality as source-oriented, consistent with this writing. First, with respect to the deprivation of intangible property theory, the district court identified the alleged misrepresentation, to which the materiality analysis applied, as “the failure to disclose to their employees that they were utilizing access to that information.” Second, with respect to the honest services fraud component of the conspiracy conviction, the district court found that the Government failed to prove that the Government employees had the requisite scienter, because the Government failed to prove that the Government employees were aware of the materiality of the information that had been sold to the leakers. The Second Circuit agreed, vacating the intangible property securities fraud component of the conspiracy conviction because the Government failed to prove scienter with respect to the honest services fraud component of the conspiracy conviction.
theory, the district court held that “one could conclude that the defendant stockbrokers . . . made a material omission to their employer by failing to disclose their relationships with the day traders.”

In sum, insider trading can potentially be prosecuted under § 1348 even if the inside information would not satisfy the investor-oriented objective materiality standard applied in § 10(b) cases. If prosecution is pursued under the classical, misappropriation, or tipping theories, an investor-oriented subjective materiality standard probably applies. Under this standard, even if a reasonable investor would not consider the inside information to be significant in making an investment decision, the information might nonetheless qualify as material if it is “capable of influencing” investors. If prosecution is pursued under the deprivation of intangible property theory or the deprivation of honest services theory, a source-oriented materiality standard probably applies. Under this standard, even if a reasonable investor would not consider the inside information to be significant in making an investment decision, the materiality element would probably be met if the source of the information would have found it significant that its confidante was using the information in this manner.

This begs the question, of course, whether there would ever be an incentive to trade on the basis of inside information that no reasonable investor would consider important. As the past 15 years have shown, however, especially in the short-term, objectively immaterial information has the potential to move the market. As such, timing one’s trades to precede the disclosure of this information could potentially be profitable.

III. Impacts of Differing Materiality Standards under § 1348 and § 10(b)

A. Chilling of Legitimate Market Behavior

As explained above, the materiality standard under § 1348 is potentially lower than the standard applied under § 10(b). Moreover, the applicable standard under § 1348 may depend on the theory that the prosecution chooses to pursue under § 1348. As market actors adjust their conduct to the specter of potential criminal prosecution under § 1348, they will likely cease even “legitimate market behavior for fear of later second-guessing by a prosecutor.”

1. Chilling of Voluntary Disclosures

In the misrepresentation context, the subjective materiality standard operates to chill voluntary disclosures. This author has previously explained the delicate balance achieved by the objective materiality standard.

The objective materiality standard for securities fraud under § 10(b) balances the fundamental importance of fair and honest markets against
the dangers of setting the materiality standard too low. On the one hand, as the Supreme Court has recognized, "[t]here cannot be honest markets without honest publicity." This consideration weighs in favor of a lower standard of materiality—both to lower the bar for required disclosures and to deter affirmative false statements. On the other hand, an unduly low standard carries its own dangers. 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.'" Moreover, when applied to affirmative misrepresentations, the materiality standard prevents “every miniscule inaccuracy in public statements of SEC filings” from being actionable, thus encouraging companies to speak voluntarily without fear of inadvertently incurring liability.

A subjective materiality standard disrupts this delicate balance. Companies and management will logically think twice before making any voluntary disclosures, for fear than even innocuous commentary could be characterized as “capable of influencing” investors. Congress has previously recognized the importance of voluntary disclosures in the context of forward-looking statements by enacting a statutory safe harbor from civil liability, with the goal of making “more information about a company's future plans available to investors and the public.” The safe harbor does not apply in criminal cases, so forward-looking statements are among the types of statements that may be chilled as a consequence of this potentially lower materiality standard.

It is worth noting that one factor counteracts the potentially chilling impact of § 1348's lower materiality standard: § 1348 only applies to fraud in connection with the securities of reporting issuers. Reporting issuers are subject to an extensive mandatory reporting scheme, so the potential chilling effect is lessened somewhat.

2. Chilling of Legitimate Uses of Information

In the insider trading context, the lower materiality standard and the related uncertainty about the applicable materiality standard may inhibit legitimate uses of information, such as engaging in securities analysis or leading a company into value-enhancing transactions.

Section 1348's materiality standards may chill securities analysis, thus interfering with the important function that analysts play in ensuring market efficiency. As the Supreme Court has recognized, market efficiency is "significantly enhanced by [analysts'] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." Analysts compile small pieces of information from a variety of sources in order to reach conclusions about the covered companies. As Professor Donna M. Nagy has explained, "[B]oth courts and the SEC have acknowledged that securi-
ties traders generally, and analysts in particular, should remain free to ‘piece seemingly inconsequential data together with public information into a mosaic' which only becomes ‘material after the bits and pieces are assembled into one picture.’ The possibility that one of these small pieces of information—which in and of itself would not be significant to a reasonable shareholder—might be deemed material for purposes of insider trading liability may prevent analysts from performing this important function. In fact, the Supreme Court recognized this very concern in Dirks v. S.E.C., when rejecting the S.E.C.'s proposed universal “disclose or abstain” rule, with a purported carve-out permitting analysts to fill in the “interstices in analysis.”

But this rule [proposed by the S.E.C.] is inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed.

Therefore, § 1348's potentially subjective and source-oriented materiality standards may chill securities analysis, interfering with its important role in the markets.

Section 1348's various materiality standards, with the uncertainty surrounding them, may also have a chilling effect on business transactions. Professor Joan MacLeod Heminway has convincingly argued that the objective “reasonable shareholder” materiality standard applied in § 10(b) cases is often unclear, such as in the contexts of improper balance sheet accounting and failed merger discussions. She argues that this ambiguity negatively affects shareholder value because of “foregone value-enhancing transactions (including issuer offerings and stock repurchases), management distractions, and outside counsel fees and disbursements.” As a solution, she contends that additional materiality guidance is needed; and in a follow-up article, she proposes the means, content, and form of this proposed materiality guidance. Section 1348 exacerbates the problem identified by Professor Heminway. In particular, the insider who is chilled from pursuing value-enhancing activities by the uncertainty surrounding the “reasonable shareholder” standard will be even more rattled by the potential that a subjective or source-specific materiality standard might apply. Similarly, the distractions and fees in the face of the uncertainty surrounding the objective investor-oriented standard are only heightened by the uncertainty surrounding the subjective or source-oriented standard.

B. Imbalance Between Civil and Criminal Liability

Section 1348 is only actionable criminally, while § 10(b) and Rule 10-b(5) are actionable both civilly and criminally. Section 1348's
lower materiality standard operates to make some misrepresentations and some insider trading actionable criminally but not civilly (even if the additional civil elements of reliance and damages are met). As this author has previously argued in the context of mail and wire fraud, this upsets the ordinary relationship between criminal and civil liability:

[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.]

This ordinary relationship between criminal and civil liability is supported by two general theories: an economic theory and a moral theory. Under economic theory, “criminal liability [which has a higher social cost than civil 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.” Under moral theory, only that subset of civilly actionable “conduct that is morally repugnant should be classified as a crime.”

The extension of the scope of criminal liability under § 1348 beyond the scope of civil liability under § 10(b) seems to turn this ordinary understanding on its head, contrary to the leading theories about the civil-criminal divide. As this author has previously postulated, however, there is one potential explanation for this inversion in the context of securities fraud, with potential support in the economic theory of the civil-criminal divide. Perhaps, in the unique context of securities fraud, the social cost of civil liability—with the disproportionate effect on the defendant company’s stock value, the spillover effects on the securities markets and the overall economy, and the immense consumption of judicial resources—actually exceeds the social cost of criminal liability, thus explaining why the relationship between civil and criminal liability is inverted in the context of securities fraud.

C. Undue Prosecutorial Discretion

Section 1348, like other broad fraud statutes, affords the prosecution tremendous discretion in assessing what conduct to prosecute. With this discretion comes a danger that enforcement decisions will be made based on improper considerations, such as bias or political motivations. Moreover, this broad discretion implicates separation of powers concerns because, by in effect criminalizing “everything” sounding in securities fraud and leaving it to the prosecutors to decide what to prosecute, Congress has delegated the law-making function to the executive branch. Although these concerns probably do not rise
to the level of unconstitutionality, they raise a policy question: whom do we want making the decision about criminality—an executive appointee or an elected body?

D. Marginal Impact of § 1348

The mail and wire fraud statutes, which are implicated in most contexts sounding in securities fraud, already apply the same lowered materiality standards discussed above.91 Indeed, this author has coined the prosecutorial decision to charge as mail or wire fraud conduct that sounds in securities fraud as the “mail/wire fraud run-around.”92 Moreover, the lower materiality standard under the mail and wire fraud statutes causes nearly identical impacts to those identified above (chilling, imbalance between civil and criminal liability, and undue prosecutorial discretion).93

Therefore, this essay must answer the following question: if the mail and wire fraud statutes have a nearly identical effect on the materiality analysis as § 1348, does the enactment of § 1348 matter? This essay contends that § 1348 has a marginal impact because, unlike the mail and wire fraud statutes, § 1348 is narrowly tailored to apply to securities fraud.

The mail and wire fraud statutes, which are not tailored to a specific type of fraud, have been pilloried, almost universally, by scholars (including this author).94 Although Congress has not responded, this criticism cannot be unheard by prosecutors. Moreover, the Supreme Court has been critical of the breadth of the mail and wire fraud statutes, issuing numerous opinions reigning them in.95 At oral argument in the Skilling case, several justices expressed concern about these statutes' potential applicability to garden-variety misconduct, such as “the employee using the computer for personal use.”96 Again, this skepticism cannot have gone unnoticed by prosecutors.

In light of this rampant skepticism, prosecutors are likely exercising their charging discretion judiciously, lest a prosecution technically within the bounds of the mail or wire fraud statute but outside the bounds of reason lead to reform. For example, at oral argument in the Skilling case, counsel for the United States responded to questions about whether ordinary misconduct could be actionable under the mail or wire fraud statutes by suggesting that the Government chooses not to prosecute run-of-the-mill cases:

I think if you look at the cases in which this has happened, there is—there’s not like a deliberation on somebody’s part—oh, do I have to disclose or not disclose? What these cases are, are really outright criminal misconduct in the form of conflicting interests that every fiduciary knows you need to disclose this before you take official action to further that interest.97

In fact, the United States Attorneys Manual cautions prosecutors...
not to use the mail and wire fraud statutes unnecessarily: "Prosecutions of fraud ordinarily should not be undertaken if the scheme employed consists of some isolated transactions between individuals, involving minor loss to the victims, in which case the parties should be left to settle their differences by civil or criminal litigation in the state courts."  

In contrast to the mail and wire fraud statutes, § 1348 is narrowly tailored to apply to conduct sounding in securities fraud, with far less potential to "metastasize." The argument that the mail and wire fraud statutes should be "repealed by implication" when the charged conduct falls within the scope of a specific fraud statute is inapplicable because § 1348 is specific. Similarly, this author cannot characterize the usage of § 1348 to prosecute conduct sounding in securities fraud as a "run-around," with the negative connotation that prosecutors are using a loophole to avoid Congress's securities fraud standards. Therefore, prosecutors are less likely to feel constrained by the potential for push-back when using § 1348 to prosecute misrepresentations that a reasonable investor would not consider important or to prosecute trading on inside information that would not satisfy the objective, investor-oriented materiality standard. The choice to prosecute the defendants in United States v. Mahaffy under the untested § 1348 criminal securities fraud statute, rather than the more predictable wire or mail fraud statutes, supports this thesis that prosecutors are less likely to feel squeamish about charging borderline conduct under § 1348 than under the mail and wire fraud statutes.  

Therefore, this essay argues that § 1348 does matter. While the "mail/wire fraud run-around" presents the theoretical possibility that immaterial misrepresentations or trading based on immaterial inside information might be prosecuted, the availability of § 1348 makes this prosecution more likely to occur.

IV. Conclusion

Section 1348 probably imposes a lower materiality standard than § 10(b). With respect to misrepresentations, a subjective materiality standard likely applies, which inquires whether the alleged misrepresentation is "capable of influencing" an investor. With respect to insider trading, several potential materiality standards apply. With respect to conduct falling within the traditional classical, misappropriation, or tipping theories, § 1348 likely applies a subjective standard, again looking at whether the inside information is "capable of influencing" an investor. With respect to conduct falling within intangible property fraud or honest services fraud, the materiality standard probably shifts from an investor-oriented standard to a source-oriented standard. Under this source-oriented standard, the focus of the inquiry is whether the source would have changed its conduct had it known about its confidante's side activities.
The potential applicability of a lower materiality standard under § 1348 than under § 10(b) has several probable outcomes. First, the lower standard and the related uncertainty likely chill legitimate market behavior, like voluntary corporate disclosures, securities analysis, and corporate transactions. Moreover, this lower standard—which criminalizes a large swathe of conduct—affords great discretion to prosecutors in deciding what conduct to prosecute, increasing the risk that bias and improper motives may affect charging decisions. Additionally, because § 1348 is actionable criminally but not civilly, the expanded scope of liability under § 1348 risks disrupting the ordinary relationship between civil and criminal liability. Although these aforementioned concerns are also implicated by the mail and wire fraud statutes, this essay contends that § 1348 imposes a marginal impact because of the Congressional stamp of approval on the use of § 1348 to prosecute conduct sounding in securities fraud.

Therefore, unless courts interpret § 1348 more narrowly than this essay suggests is likely or Congress amends the statute, market participants should be wary of the potentially lower materiality standard under § 1348. Courts, when interpreting § 1348, should consider whether some of the concerns raised in this essay compel a more limited interpretation of § 1348, despite § 1348’s mimicking of the mail, wire, and bank fraud statutes. Finally, Congress, when considering the appropriate incentives to encourage voluntary disclosure, securities analysis, and corporate transactions, should remember the impacts of criminal statutes like § 1348, which can run roughshod over even the most carefully crafted civil regulatory scheme.

NOTES:

15 U.S.C.A. § 78j(b) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device . . . .")

215 U.S.C.A. § 78ff(a). For a natural person, the penalty for violating § 32(a) is a fine of up to $5 million, imprisonment of not more than 20 years, or both. For a defendant that is not a natural person, the penalty is a fine of up to $25 million. Id.

3Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L.J. 1521, 1523 (2005) ("SOX was enacted in a flurry of congressional activity in the runup to the midterm 2002 congressional elections after the spectacular failures of the once highly regarded firms Enron and WorldCom.").

4By its terms, 18 U.S.C.A. § 1348 limits its applicability to securities "of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78o(d))." Consistent with common us-
This essay refers to these issuers who must file periodic reports with the Securities and Exchange Commission as “reporting issuers.”


17 C.F.R. § 240.10b-5.


Id. at 23 n.7 (citing U.S. v. Wells, 519 U.S. 482, 117 S. Ct. 921, 137 L. Ed. 2d 107 (1997)).

Id. (explaining that statutes that “prohibit both ‘false’ and ‘fraudulent’ statements or information” do not imply a materiality requirement).


Neder, 527 U.S. at 20.

Neder, 527 U.S. at 25.


See Sarbanes-Oxley Act § 807(a) ("Chapter 63 of title 18, United States Code, is amended by adding at the end the following: 'Sec. 1348. Securities Fraud.'").

I.N.S. v. National Center for Immigrants' Rights, Inc., 502 U.S. 183, 189, 112 S. Ct. 551, 116 L. Ed. 2d 546 (1991) ("In other contexts, we have stated that the title of a statute or section can aid in resolving an ambiguity in the legislation's text."); e.g., Mead Corp. v. Tilley, 490 U.S. 714, 723, 109 S. Ct. 2156, 104 L. Ed. 2d 796, 10 Employee Benefits Cas. (BNA) 2569 (1989) ("Finally, any possible ambiguity is resolved against respondents by the title of § 4044(a) [allocation of assets].")


Id. at 22 n.5 (quoting the Restatement Second, Torts § 538 (1977)).

See O'Malley, Grenig, and Lee, Federal Jury Practice and Instructions § 47:33 (6th ed.) (compiling the pattern jury instructions for mail and wire fraud from each circuit). The Gaudin definition is included in the pattern jury instructions for the First, Fifth, Sixth, Eighth, Ninth, Tenth, and Eleventh Circuits. Id.

U.S. v. Swete, 556 F.3d 1157, 1164, R.I.C.O. Bus. Disp. Guide (CCH) ¶ 11947 (11th Cir. 2009) (en banc) ("All the sources cited by the Supreme Court [in Neder] support the proposition that materiality may be proved without establishing that the misrepresentation was objectively reliable."); U.S. v. Davis, 226 F.3d 346, 358-59 (5th Cir. 2000) ("Under these [Neder] definitions, a statement could indeed by material, even though only an unreasonable person would rely on it, if the maker knew or had reason to know his victim was likely so to rely. Davis's argument that a misrepresentation must be one on which a reasonable person would rely ignores this alternative way of showing materiality."); United States Attorneys' Manual § 9-43:943 (citing various authorities for the proposition that "gullible victims" do not prevent conviction under the mail and wire fraud statutes).

Note, however, that one district court has applied the § 10(b) objective materiality standard in a prosecution under § 1348, although neither party argued that the Neder subjective materiality standard should apply. Memorandum and Order, United States v. Brooks, No. 2:06-CR-550-JS-ETB, at 4 (E.D.N.Y. Jan. 25, 2010) (docket number 781) (citing Neder in support of the materiality requirement under § 1348 and citing Basic in support of the stated objective materiality standard).

of a transaction commits fraud only when he is under a duty to do so.

"Chiarella, 445 U.S. at 227–28 ("At common law . . . [o]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only"

"Id. at 255 ("When an allegation of fraud is based on nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.")"


"Chiarella, 445 U.S. at 227 ("That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law.").

"O'Hagan, 521 U.S. at 652.

"Id. at 655 ("Because the deception essential to the misappropriation theory involves feigning fidelity to the source of the information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation.").

"Dirks, 463 U.S. at 660.

"Id. at 662.

"18 Insider Trading Regulation, Enforcement and Prevention § 5.2 (2012).

"18 Insider Trading Regulation, Enforcement and Prevention § 6:5 (2012) ("There is a respectable argument that the test for materiality should not be based on what other investors would likely think, because the fraud is on the source of the information, not on other investors."); U.S. v. Elliott, 711 F. Supp. 425, 433, Fed. Sec. L. Rep. (CCH) ¶ 94512 (N.D. Ill. 1989) ("In a misappropriation case, however, where the focus is on the insider's duty to the corporation, it would be incongruous to have a materiality standard based on the outsider's point of view. Rather, we believe it is enough . . . if a reasonable corporate executive would believe keeping that information confidential was valuable to the corporation.").

"18 Insider Trading Regulation, Enforcement and Prevention § 6:5 (2012) ("When the misappropriation theory was first articulated, it was generally assumed that liability would result only if the wrongdoer misappropriated information that was material and nonpublic in the traditional securities law sense . . . -i.e., that the information was of the sort that a reasonable investor would likely consider significant in buying or selling . . . Whether this assumption is correct, however, is an interesting, relatively unexplored question even many years after the misappropriation theory gained acceptance."); Nagy, Insider Trading, Congressional Officials, and Duties of Entrustment, 91 B.U. L. Rev. 1105, 1128 (2011) (citing authority for the application of the "reasonable investor" materiality standard in insider trading cases, regardless of the theory of prosecution); S.E.C. v. Talbot, 530 F.3d 1085, 1097–98, Fed. Sec. L. Rep. (CCH) ¶ 94765 (9th Cir. 2008) (applying the "reasonable investor" materiality standard in an insider trading case premised on the misappropriation theory).


"E.g., Neder, 527 U.S. at 21–23.

Id. at 26-27 (explaining that “exclusivity is an important aspect of confidential business information.”)


This example is drawn from the facts alleged in Carpenter v. U.S., 484 U.S. at 25, 108 S. Ct. 316, 98 L. Ed. 2d 275, 14 Media L. Rep. (BNA) 1553, 5 U.S.P.Q.2d 1699, Fed. Sec. L. Rep. (CCH) ¶ 93423, R.I.C.O. Bus. Disp. Guide (CCH) ¶ 6785 (1987). In Carpenter, which was decided more than a decade before Neder, the Court did not explicitly address the question of materiality. However, the court identified the actionable promise as the “undertaking . . . not to reveal prepublication information about his column.” Id. at 27.


See Skilling, 130 S. Ct. at 2934 (suggesting that, if Skilling had “solicited or accepted side payments from a third party” in exchange for making misrepresentations, his conduct might have qualified as a bribe or kickback).

U.S. v. Milovanovic, 678 F.3d 713, 727 (9th Cir. 2012) (analyzing the element of materiality in a case where state employees allegedly deprived the state of their honest services by accepting bribes to issue licenses to unqualified applicants) (“The misrepresentation or omission at issue for an ‘honest services’ fraud conviction must be ‘material,’ such that the misinformation or omission would naturally tend to lead the ‘victim’ to be ‘material,’ such that the misrepresentation or omission would naturally tend to lead the ‘victim’ to conclude that U.N. personnel were less inclined to downplay the need for verifying . . . [their] past experience.”); U.S. v. Rybicki, “the victim’s knowledge of the scheme would tend to cause the victim to change his or her behavior.”

55Mahaffy, 2006 WL 2224518.

65Mahaffy, 693 F.3d at 119.

Id. at *16; see also id. at *13 (recognizing that the element of materiality would be met if the brokerage firms would have changed their conduct upon exposure of their brokers’ dual allegiances).

Breen & Miller, supra note 8, at 51 ("One might imagine that in certain cases the fact that materiality under § 1348 is evaluated from an employer’s, rather than investor’s, perspective could prove the difference between conviction and acquittal of a trader who acts upon information that would not be considered material under Rule 10b-5.").

See Couture, Price Fraud, 63 Baylor L. Rev. 1, 8 (2011) ("The existence of asset bubbles contradicts the long-held assumption, supported by the efficient-market hypothesis, that markets are always right. Indeed, a new wave of economic thought recognizes that investors sometimes act irrationally, causing market prices to deviate from fundamental value."); Fisher, Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?, 54 Emory L.J. 843, 897–98 (2005) ("Something happened during The Bubble to sever the relationship between the price of stock and the underlying fundamental value of the companies issuing stock. ... It could be quite true that, during The Bubble, stocks moved in response to information. But the circumstance that prices were no longer grounded in value suggests the strong possibility that the prices from which stocks moved and the prices to which they moved were not rational. Indeed, the crazy prices and wild market movements suggest that in some cases prices may have changed in response to information even when rational market participants would not have bought or sold on the information at all."); contra 18 Insider Trading Regulation, Enforcement and Prevention § 6:5 (2012) ("[I]t is also true that the misappropriator by trading will not profit from the misuse of the information unless it is material (and nonpublic) in the more traditional sense.").


Basic, 485 U.S. at 230 (quoting H.R. Rep. No. 73-1383, at 11 (1934)); see also 15 U.S.C.A. § 78b (2000) (stating that one purpose of securities regulation is “to insure the maintenance of fair and honest markets”); Basic, 485 U.S. at 230 (recognizing that a central purpose of the securities laws is “to protect investors against manipulation of stock prices”); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (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”).

Basic, 485 U.S. at 231 (quoting TSC Indus., 426 U.S. at 448–49).


73 15 U.S.C.A. §§ 78m(a) & 78o(d) (requiring reporting issuers to file annual and quarterly reports as prescribed by the S.E.C.); 17 C.F.R. §§ 240.13a-1 and 240.15d-13 (imposing an annual report filing requirement); 17 C.F.R. §§ 240.13a-13 and 240.15d-13 (imposing a quarterly filing requirement).


76 Dirks, 463 U.S. at 658–59 (“It is commonplace for analysts to ferret out and analyze information..., and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analyst obtain normally may be the basis for judgments as to the market worth of a corporation’s securities.”) (internal citation omitted).

77 Dirks, 463 U.S. at 658 n.17 (quoting the S.E.C.’s brief).

78 Id.


80 Id. at 1141; see id. at 1172–82.

81 Id. at 1191 (“Whether that guidance comes in the form of legislation, SEC rulemaking, SEC interpretive advice, or (at a bare minimum) more methodical, rigorous decision making in the courts, enhanced guidance is warranted.”).

82 Heminway, Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading, 72 La. L. Rev. 999, 1001 (2012) [hereinafter Heminway, Just Do It!] (“This article then proceeds... to propose the desired materiality guidance, identify the SEC as the most appropriate rulemaking body to adopt the guidance, and suggest a specific form in which the guidance should be issued.”).

83 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749, 95 S. Ct. 1917, 44 L. Ed. 2d 539, Fed. Sec. L. Rep. (CCH) ¶ 95200, 1975–76 Trade Cas. (CCH) ¶ 60351 (1975) (holding that purchasers and sellers have an implied right of action under § 10(b)); 15 U.S.C.A. § 78f-1 (providing that any person who violates the insider trading provisions of the 1934 Act is liable to contemporaneous traders).

84 Couture, White Collar Crime, supra note 66, at 42 (citing authority); see also Couture, White Collar Crime, supra note 79, at 1183–91 (detailing how insider trading lawsuits decrease the value of shareholders’ ownership interests without proportionate benefit to shareholders).

85 Couture, White Collar Crime, supra note 66, at 47 (citing authority).

86 Id. at 51 (citing authority).

87 Id. at 49–50 (citing authority).

88 Heminway, Just Do It!, supra note 82, at 1010–11 (explaining that “the vagueness of aspects of the legal standard for insider trading liability under Rule 10b-5 (including the materiality element)” introduces the risk of “enforcement biases”); Sabino and Sabino, From Chiarella to Cuban: The Continuing Evolution of the Law of Insider Trading, XVI Fordham J. Corp. & Fin. L. 673, 736 (2011) (bemoaning the “dangers of unbridled prosecutorial power” associated with the misappropriation
Enforcement agents may exercise their discretion to enforce insider trading prohibitions against some buyers, sellers, tippers, or tippees—and not others—for reasons unrelated to the policy objectives underlying insider trading regulation."

Couture and Gerwick, Evolutionary Biology, supra note 65, at 88 (citing authority).

Couture, White Collar Crime, supra note 66, at 4 (“Virtually every statement that could form the basis of a securities fraud claim . . . is disseminated via the wires or mail, thus satisfying the jurisdictional requirement for mail or wire fraud.”); Pazicky, supra note 22, at 802 (“It seems like the Securities Fraud Statute will only nominally impact federal securities fraud prosecutions. First, the mail and wire fraud statutes are written and interpreted flexibly, and it seems like these ‘catch-all’ provisions cover nearly all securities fraud schemes.”); id. at 823 (“After all, it is extremely unlikely that a securities defrauder could orchestrate a scam without at some point using the mail or wire systems in furtherance of his or her scheme.”).

Couture, White Collar Crime, supra note 66 at 4–8. Note that the mail and wire fraud statutes do not supply the only “run-around.” For example, alleged misrepresentations in reports filed with the S.E.C. can be prosecuted under 18 U.S.C.A. § 1001. U.S. v. Bilzerian, 926 F.2d 1285, 1299–1300, Fed. Sec. L. Rep. (CCH) ¶ 95701, 31 Fed. R. Evid. Serv. 1185 (2d Cir. 1991). Section 1001 applies the same materiality standard as the wire and mail fraud statutes. U.S. v. Gaudin, 515 U.S. 506, 509, 115 S. Ct. 2310, 132 L. Ed. 2d 444 (1995) (“The statement must have a ‘natural tendency to influence, or [be] capable of influencing, the decision of the decisionmaking body to which it was addressed.’”) (citation omitted).

Couture, White Collar Crime, supra note 66, at 28–41.

Couture and Gerwick, Evolutionary Biology, supra note 65, at 86–69 (compiling critical sources).

E.g., Skilling, 130 S. Ct. 2896; Cleveland, 531 U.S. 12; McNally, 483 U.S. 350.


Couture and Gerwick, Evolutionary Biology, supra note 65, at 92–93 (citing case and scholarly authority for “repeal by implication” in the context of mail and wire fraud).

Compare Couture, White Collar Crime, supra note 66, at 4–12.