SEC's authority to interpret the securities laws comes under fire in criminal enforcement

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Abstract

Purpose – *To examine a statement issued by Justice Antonin Scalia on November 10, 2014, concurrently with the Supreme Court's denial of certiorari in a criminal insider trading case, which raises profound questions about how the courts interpret the federal securities laws and the degree of deference they give to the Securities and Exchange Commission (SEC) in the context of criminal enforcement.*

Design/methodology/approach – *The article discusses the points raised in the justice's statement and their potential implications for future securities enforcement cases.*

Findings – *The statement suggests that the traditional deference courts accord the SEC under the landmark decision in Chevron USA Inc. v. Natural Resources Defense Council, Inc., 467 US 837 (1984) may be inappropriate and potentially inconsistent with the rule of lenity, which requires that ambiguous criminal laws be interpreted in a defendant's favor.*

Originality/value – *Expert guidance from experienced securities lawyers.*

Keywords *Securities and exchange commission, Securities enforcement, Judicial deference, Rule of lenity, Criminal liability*

Paper type *Research paper*

A statement issued by Justice Antonin Scalia on November 10, 2014, concurrently with the Supreme Court's denial of certiorari in a criminal insider trading case raises profound questions about how the courts interpret the federal securities laws and the degree of deference they give to the Securities and Exchange Commission (SEC) in the context of criminal enforcement.

Hedge fund manager Doug Whitman was convicted in 2012 on evidence that he traded the stock of several public companies after receiving inside information. Whitman was convicted under Section 10(b) of the Securities Exchange Act, the principal antifraud statute governing insider trading, which makes it unlawful to "use or employ" a deceptive device or contrivance in connection with the purchase or sale of a security. On appeal to the 2nd Circuit, Whitman argued that he was prejudiced by the trial judge's instruction to the jury that it could find him guilty if inside information was "at least a factor" in his trading decision. Whitman contended that the threshold should be higher, requiring proof that inside information was a *significant factor* in his trading decision, consistent with the law in the 9th Circuit.

In rejecting Whitman's argument, the 2nd Circuit cited to an earlier decision that deferred to SEC Rule 10b5-1, a rule that defines what it means to trade "on the basis of" inside information – in other words, the circumstances when a defendant can be deemed to have "used or employed" inside information within the meaning of Section 10(b). Rule 10b5-1 states that it is enough if a defendant was "aware" of inside information when trading, a lower standard than the one Whitman advocated in his

appeal before the 2d Circuit. Under the Supreme Court's decision in *Chevron USA Inc. v. Natural Resources Defense Council, Inc.*, 467 US 837 (1984), federal courts generally defer to an executive agency's interpretation of an ambiguous law so long as it is reasonable. On that basis, the 2nd Circuit relied on the SEC's interpretation of Section 10(b) as reflected in Rule 10b5-1, rejected Whitman's argument, and affirmed the trial court's jury instruction.

Whitman's petition for certiorari to the Supreme Court did not challenge this part of the 2nd Circuit's ruling. Nevertheless, Justice Scalia issued a statement accompanying the denial of certiorari, joined by Justice Clarence Thomas, in which he expressed doubts on whether deference to the SEC is appropriate when a court interprets a law, such as Section 10(b), that can give rise to criminal liability. Scalia contended that *Chevron* deference in such circumstances "collide[s] with the norm that legislatures, not executive officers, define crimes," and in effect allows civil regulators to create "new crimes at will" – a concern that is especially pointed when civil regulators, such as the SEC, have a tradition of close collaboration with criminal prosecutors in law enforcement.

Scalia acknowledged that Congress could make it a crime to violate an SEC rule, but thought it a stretch to "presume" that Congress gave the SEC the "power to resolve ambiguities in criminal legislation," especially since the SEC's authority extends only to civil enforcement of the securities laws. It may be argued, however, that this is what Congress intended to do with Section 10(b), which criminalizes fraud "in contravention of such rules and regulations as the [SEC] may prescribe" – language that appears to empower the SEC to define the parameters of criminal liability. Under the Supreme Court's "intelligible principle" doctrine, Congress can delegate legislative power to the executive branch, so long as the bounds of delegation are intelligibly defined. Scalia acknowledged that in the decades since the Supreme Court decided *Chevron*, federal courts have often deferred to "executive interpretations" by government agencies "of a variety of laws that have both criminal and administrative applications." Indeed, Scalia himself joined a unanimous Supreme Court ruling deferring to the SEC's interpretation of another part of Section 10(b), albeit in a civil enforcement context, in *SEC v. Zandford*, 535 US 813 (2002).

Nevertheless, in his statement Scalia invited future cases challenging the deference owed by the courts to SEC interpretations of the securities laws in criminal cases, saying he would be "receptive to granting" a petition that properly presented the question. This all but ensures that Scalia's arguments will become commonplace in criminal securities prosecutions in the lower courts in the years to come.

In his statement, Scalia also raised a second challenge to *Chevron* deference to the SEC in criminal securities cases, arguing that such deference would violate the "rule of lenity," a canon of construction that requires courts to interpret ambiguous criminal laws in a defendant's favor. Scalia recognized that the Supreme Court had previously considered and rejected the argument that the rule of lenity trumps *Chevron* deference, but dismissed the Court's earlier decision as a "drive-by ruling." And he further suggested that several other decisions of the high court have independently recognized that if a law can be enforced both criminally and civilly, "the rule of lenity governs its interpretation in both settings."

If Scalia's objections gain momentum, this could have far-reaching implications for criminal securities enforcement and for the SEC more generally. Since many of the laws the SEC enforces can give rise to criminal sanctions, the SEC could be denied deference in a wide range of cases, leaving its rules subject to frequent challenge. Scalia's statement could also invite litigants to argue that the rule of lenity compels courts to interpret various provisions of the securities laws against the SEC even in civil

enforcement cases, an argument that historically had little currency against the agency.

Justice Scalia's statement has no precedential weight, but it indicates that two of the justices of the Supreme Court are amenable to reconsidering the deference owed to the SEC's interpretation of the federal securities laws in criminal and perhaps also civil cases. At a minimum, their views will likely lead to an uptick in litigation in the lower courts in cases alleging violations of the securities laws.

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