The Rule Of Lenity And The Enforcement Of The Federal Securities Laws

Anna Currier
American University Washington College of Law

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COMMENT

THE RULE OF LENITY AND THE ENFORCEMENT OF THE FEDERAL SECURITIES LAWS

ANNA CURRIER*

In 1984, the Supreme Court of the United States ruled in Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc. ("Chevron") that courts owe deference to an executive agency's interpretation of a statute. On November 10, 2014, the Supreme Court in Whitman v. United States, a criminal insider trading case, denied a petition for writ of certiorari. In a statement accompanying the denial of certiorari, Justice Scalia questioned whether a federal court owed deference to an executive agency's interpretation of a statute that has both criminal and administrative applications. The crux of Justice Scalia's concern is that the Securities and Exchange Commission (the "Commission" or "SEC"), through its rulemaking authority, is usurping the role of Congress by defining criminal conduct. Specifically, Justice Scalia reiterated his belief that the rule of lenity requires that any ambiguity arising from the applicable law in a criminal case must be resolved in favor of the defendant and that Chevron deference must yield to lenity where a statute has both criminal and administrative application.

This Comment will examine the impact on the enforcement of the federal securities laws by the Commission and the Department of Justice ("DOJ") and whether Chevron deference should be required to give way to the rule of lenity where a Commission rule or statute has both criminal and administrative application, specifically Section 10(b), Rule 10b-5, Rule 10b5-1, and Rule 10b5-2. This Comment will also consider how the application of the rule of lenity will affect the national market system and the public investors.

* I would like to thank my family and Alan Lieberman for their continued support and guidance during this process.
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INTRODUCTION

Since the Supreme Court’s landmark decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council Inc.* ("Chevron"), it has been settled law that courts owe deference to an executive agency’s interpretation of a “statutory scheme it is entrusted to administer . . . .”¹ The principle, of whether statutory construction will continue to apply in cases involving the enforcement of the federal securities laws, is now in question.

Included in Justice Scalia’s concurrence in *Whitman* was an invitation of sorts, expressing his favorable disposition toward granting certiorari in a case that presented the Supreme Court with the opportunity to decide

whether lenity trumps deference where a rule or statute has both administrative and criminal application. The implication of Justice Scalia’s concurrence for the enforcement of the federal securities laws are unprecedented in their scope and impact.

In *Whitman v. United States*, Whitman had been convicted of insider trading as a secondary tippee, and the Second Circuit affirmed his conviction. The Second Circuit followed this rationale in *United States v. Royer*, which held that a defendant commits insider trading in violation of Section 10(b) when he trades “while in knowing possession of nonpublic information material to those trades.” Royer was based in part on the Court’s reading of the Commission’s interpretation of Rule 10b5-1, which defines insider trading as a manipulative and deceptive device and adopts an awareness standard for insider-trading liability under Section 10(b).

In December 2014, the Second Circuit (“Court”) decided another criminal insider trading case: *United States v. Newman*. In *Newman*, the

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2. See *Whitman v. United States*, 135 S. Ct. 352, 352, 354 (2014) (“A court owes no deference to the prosecution’s interpretation of a criminal law . . . investigator Whitman does not seek review on the issue of deference . . . [s]o I agree with the Court that we should deny the petition. But when a petition properly presenting the question comes before us, I will be receptive to granting it.”).


4. United States v. Whitman, 904 F. Supp. 2d 363, 365 (S.D.N.Y. 2012) (“Specifically, the counts charged that Mr. Whitman traded or agreed to trade on material inside information that he received from tippees who had, in turn, obtained the information from inside employees . . . .”).

5. United States v. Whitman, 555 F. App’x. 98, 107 (2d Cir. 2014) (finding no error in the jury instruction on appeal and affirming Whitman’s conviction).

6. Id. (quoting United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008)).

7. *Royer*, 549 F.3d at 899 (deferring to the Commission adoption of a knowledge requirement in Rule 10b5-1).

8. 17 C.F.R. § 240.10b5-1(a) (2011) (“The ‘manipulative and deceptive devices’ prohibited by Section 10(b) of the [Securities Exchange] Act (15 U.S.C. § 78j) and §240.10b-5 . . . include . . . the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholder of that issuer, or to any other person who is the source of the material nonpublic information.”).

9. See id. § 240.10b5-1(b) (stating that a purchase or sale of security is “on the basis of” material nonpublic information if the person making the purchase or sale was “aware” of the material nonpublic information when the sale was made).

10. See United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014) (establishing that appellants Newman and Chiasson were appealing from judgments of conviction
U.S. Attorney’s Office for the Southern District of New York ("Government") argued that it was sufficient to prove a violation under Rule 10b5-2 by showing that a tippee had traded on material, nonpublic information with knowledge that the information was tipped in breach of a fiduciary duty. The Second Circuit rejected this formulation and, appearing to implicitly adopt Justice Scalia’s approach, the Court embraced a standard that imposed a heavier burden on the Government. This heavier burden was exemplified by the Court’s holding that a breach of fiduciary duty is only committed if there is a personal benefit to the tipper, and the Government must prove beyond a reasonable doubt that the tippee had knowledge of both the fiduciary duty and the personal benefit. The Second Circuit in Newman defined personal benefit with specificity; the Court held that the Government would need to prove a “meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature,” and the Government must bring evidence of “a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].” Newman relied in part on the Supreme Court’s decision in Dirks v. SEC, a civil insider trading case decided before the Commission had promulgated Rules 10b5-1 and 10b5-2.

On July 30, 2015, the Government filed a petition for writ of certiorari with the Supreme Court. In the petition, the Government argued that Newman’s holding sharply contrasted with Dirks because the former opinion articulated a heightened personal benefit requirement that rejected Dirks’ previous definition of personal benefit, a benefit that was explained by the Second Circuit as one that could be “inferred from a personal relationship between the tipper and the tippee.”

11. Id. at 447 (stating that the Government felt it only needed to prove “[t]hat the ‘defendants traded on material, nonpublic information they knew insiders had disclosed in breach of a duty of confidentiality”).

12. Id. at 450.

13. Id.


This Comment will discuss Newman’s potential impact on the enforcement of federal securities laws. Specifically, it examines whether subordinating deference to the rule of lenity, combined with a federal court’s denial of deference to the Commission in insider trading prosecutions brought under Rule 10b-5 as recently seen in Newman, signals an important change in the enforcement of the federal securities laws in criminal proceedings.

Section I will review the Commission’s rulemaking and enforcement authority. First, this Section will review the adoption of the Securities Act of 1934, specifically Section 10(b), and the Commission’s subsequent promulgation of Rule 10b-5, Rule 10b5-1, and Rule 10b5-2, which interpret Section 10(b). Second, it will review the case law that implemented Congress’ intent that the Commission and DOJ cooperate and enforce the anti-fraud provisions of the federal securities laws. Third, it will discuss the application and importance of Chevron deference to the Commission’s enforcement of the federal securities laws. Fourth, it will examine the pertinent and relevant case history, demonstrating the federal courts deference (or lack thereof) to the Commission’s interpretation of Rule 10b-5 for insider trading liability.

The tension between Chevron deference and the rule of lenity is best understood in the development of the law of insider trading. Section II will analyze how applying the rule of lenity to the Commission’s interpretation of Rule 10b-5 in both civil and criminal cases will affect the Commission’s enforcement power for insider trading cases and, ultimately, the investing public.

In Section III, this Comment will recommend that federal courts should apply the rule of lenity in criminal prosecutions for insider trading. This Comment will conclude by setting the boundaries for Commission deference in criminal prosecution cases concerning insider-trading liability under Rule 10b-5.

I. THE SECURITIES LAWS AND THE COMMISSION’S RULEMAKING AUTHORITY

A. The Commission’s Adoption of Rules Implementing Section 10(b)

In 1933 and 1934, following the market crash of the Great Depression,17 Congress enacted the Securities Act of 193318 (the “Securities Act”) and

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the Securities Exchange Act of 1934\(^{19}\) (the "Exchange Act"). These laws were enacted to address and prevent an array of abuses of the public markets.\(^{20}\) The principal anti-fraud provision of the Exchange Act is Section 10(b). Congress determined that the best antidote to securities fraud was full material disclosure of information to the investing public in connection with the purchase or sale of securities, and it created Section 10(b) as the catchall anti-fraud provision.\(^{21}\) Congress delegated rule-making authority to the Commission to implement the provisions of Section 10(b).\(^{22}\) In fulfilling this congressional mandate, the Commission adopted Rule 10b-5,\(^{23}\) Rule 10b5-1,\(^{24}\) and Rule 10b5-2.\(^{25}\) Rule 10b-5 prohibits the employment of fraudulent or deceitful devices in connection with the purchase or sale of securities.\(^{26}\) Rule 10b5-1, adopted nearly six decades after Rule 10b-5,

defines when a purchase or sale of securities constitutes trading 'on the basis of' material nonpublic information in insider trading cases brought under... Rule 10b-5... if the person making the purchase or sale of securities was aware of the material nonpublic information when the person made the purchase or sale.\(^{27}\)

Rule 10b5-2, adopted in the same year as Rule 10b5-1, prohibits "the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence."\(^{28}\)

Rule 10b-5, adopted in 1942,\(^{29}\) was intended to provide investors an even

\(^{19}\) Id. § 78a (2015).

\(^{20}\) See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669 (1984) ("[The Acts]... have two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued periodically thereafter.").

\(^{21}\) See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) ("[Rule 10(b)] was described... as a ‘catchall’ clause to enable the Commission ‘to deal with new manipulative (or cunning) devices.’").

\(^{22}\) See 15 U.S.C. § 78j(b) (2015) ("[I]t shall be unlawful for any person, directly or indirectly... [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.").


\(^{24}\) Id. § 240.10b5-1.

\(^{25}\) Id. § 240.10b5-2.

\(^{26}\) Id. § 240.10b-5 (barring any person from employing any “device, scheme, or artifice to defraud... in connection with the purchase or sale of any security”).

\(^{27}\) Id. § 240.10b5-1.

\(^{28}\) Id. § 240.10b5-2 ("misappropriation theory").

\(^{29}\) See Press Release, SEC, No. 3230 (May 21, 1942) (announcing that the
playing field for trading in the public market. To provide clarity to a rule that invited varying court interpretation, the Commission promulgated Rules 10b5-1 and 10b5-2 in 2000. The rules seek to prevent insiders from benefitting from their positions of power by trading on confidential inside information. A Rule 10b-5 violation occurs when trading relies upon information that would reasonably be expected to affect the market price.

B. The Commission’s Enforcement Power and Rulemaking Authority

The Commission’s Enforcement Division ("Enforcement Division") investigates and prosecutes those who violate the federal securities laws. The Enforcement Division has broad power to manage investigations of potential violations of the securities laws through statutory authority. The Penny Stock Reform Act of 1990 ("Reform Act") significantly enhanced the enforcement remedies the Commission could seek in federal court and administrative proceedings. The Act gave administrative law judges power to impose civil penalties through administrative proceedings.

Commission had adopted a rule (Rule 10b-5) prohibiting fraud by any person in connection with the purchase of securities.

30. See SEC v. Tex. Gulf Sulphur, Inc., 401 F.2d 833, 848 (2d Cir. 1968) (explaining that Rule 10b-5 is based in the policy that all investors trading in the marketplace should have equal access to information).

31. See generally SEC v. Zandford, 535 U.S. 813, 813–14 (2002) (holding that Section 10(b) should be construed "flexibly" and that the Commission’s broad reading of the statute should be entitled deference).

32. See supra note 15.


34. Compare Arthur Fleischer, Jr., Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1289 (1965) (explaining importance of disclosures under Rule 10b-5 being limited to situations that are "extraordinary in nature" and also "which are reasonably certain to have a substantial effect on the market price if the security is disclosed"), with Tex. Gulf Sulphur, Inc., 401 F.2d at 848 (2d Cir. 1968) (holding that an insider may not always be excluded from trading in his own company because he is more familiar with it than outsiders).


The endemic greed and looting of corporate assets and fraudulent financial reporting that caused the collapse of Enron and WorldCom led to the enactment of the Sarbanes-Oxley Act in 2002 ("Sarbanes-Oxley"). Under Sarbanes-Oxley, the Commission was able to obtain director and officer bars in administrative proceedings, a remedy the Commission could previously only obtain in federal court. Congress addressed the 2008 financial crisis with the passage of the Dodd-Frank Act ("Dodd-Frank"), which enhanced the Commission’s enforcement power and rulemaking authority. As with the Reform Act and Sarbanes-Oxley, Dodd-Frank expanded the Commission’s penalty options, specifically the ability to impose civil penalties in administrative cease-and-desist proceedings brought under the Securities Act and the Exchange Act: penalties the Commission could previously only obtain in federal court. As a result of this enhanced power, the Commission has opted to file more of its enforcement actions as administrative proceedings, particularly in insider trading actions.

The Commission has not only been endowed with greater regulatory powers through legislation, but it has also been influenced by its Commissioners. Chairwoman Mary Jo White has encouraged the Commission to enforce the federal securities laws in accordance with a "broken windows policy"—a policy that seeks to pursue all types of federal securities violations no matter their severity. By expanding the Commission’s reach, Chairwoman White’s enforcement program created a

39. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 705(b), 116 Stat. 745, 799–800 (2002) ("Sarbanes-Oxley Act") (requiring the office of the Comptroller General to submit a report to Congress indicating whether the financial industry had assisted public companies with fraudulent reporting; regulatory and statutory recommendations were also to be included in the report).

40. Id. § 1105(a)(f) (granting the Commission authority to proscribe any person who violates Section 10(b) or any “rules or regulations thereunder” from serving as an officer or director).

41. See Atkins, supra note 37, at 395 (explaining that officer and director bars were previously only enforced in civil actions after showing of unfitness).


43. Id. § 929P.

44. See Sarah N. Lynch, U.S. SEC to File Some Insider-Trading Cases in its In-house Court, REUTERS (June 11, 2014, 4:09 PM), http://www.reuters.com/article/2014/06/11/sec-insidertrading-idUSL2N0OS1AT20140611 (reporting on Division of Enforcement Director Andrew Ceresney’s comments that the SEC intends to bring more insider trading cases in the administrative forum).

45. Mary Jo White, Chairwoman, SEC, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539872100 ("Minor violations that are overlooked or ignored can feed bigger ones . . . .").
C. Parallel Enforcement of the Federal Securities Laws by the Commission and DOJ

As a civil agency, the SEC’s Enforcement Division brings civil suits in both federal court and administrative forums. The Commission exercises its discretion in determining whether to prosecute violations in federal court or in an administrative proceeding. The principal anti-fraud provisions of the federal securities laws have both civil and criminal applications, and “Congress has expressly authorized the SEC to share information with the [DOJ] to facilitate the investigation and prosecution of crimes.” The Commission and the DOJ cooperate in prosecuting fraud in the securities markets, and the two agencies often conduct concurrent investigations and prosecutions. The DOJ frequently utilizes Sections 1341, 1343, and 1348 of Title 18 to prosecute violations of federal securities laws. As with Rule 10b-5, these criminal statutes prohibit “a scheme or artifice to defraud.” The DOJ can also use Section 371 of Title 18 to charge conspiracies in violation of securities fraud.

1. The Commission’s and DOJ’s Different Burdens

In Steadman v. SEC, the Supreme Court held that Congress intended the Commission to use a preponderance standard in its proceedings. A
preponderance standard, seen as the “[l]ightest burden of proof to modern law,” has traditionally been imposed in civil proceedings. In criminal actions where the rule of lenity is applied, elements of securities fraud must be proven by the government beyond a reasonable doubt. The DOJ, by having to show that the defendant acted “willfully” in committing a violation of a federal securities law, is required to prove a heightened mental state under a higher evidentiary burden. Despite the two agencies’ different burdens of proof, their investigations of federal securities law violations frequently intersect. The securities laws also allow the Commission to share the evidence it accumulates while conducting its civil investigations with United States Attorneys for the purpose of facilitating a criminal investigation. In United States v. Stringer, the Ninth Circuit approved the Commission’s role in sharing information with the DOJ to facilitate the DOJ’s own investigation and prosecution of crimes. The Commission and the DOJ also liberally share investigation materials. For example, Form SEC 1662 is sent to all witnesses who are subpoenaed to

authority that Congress intended that Commission disciplinary proceedings, subject to § 7 of the APA, be governed by a preponderance-of-the-evidence standard.”).


56. See Annotation, Instructions Defining Term “Preponderance or Weight of Evidence”, 93 A.L.R. 155 (1934) (“There is no doctrine of the law settled more firmly than the rule which authorizes issues of fact in civil cases to be determined in accordance with the preponderance or weight of the evidence.”).


58. Compare 15 U.S.C. § 78ff(a) (2015) (stating that any person who “willfully violates any provision of this chapter [including 15 U.S.C. § 78j] or any rule or regulation thereunder... shall upon conviction be... imprisoned not more than 20 years...”), with 17 C.F.R. § 240.10b5-1 (2011) (stating that a purchase or sale of security is “on the basis of” material nonpublic information if the person making the purchase or sale was “aware” of the material nonpublic information when the sale was made).

59. See Division of Enforcement Manual, supra note 50 (explaining that parallel criminal and civil proceedings are common and that the Commission should share investigation materials and coordinate investigations “when appropriate”).

60. See 15 U.S.C. § 77t(b) (allowing the Commission to convey evidence concerning violations of the securities laws to the Attorney General).

61. United States v. Stringer, 535 F.3d 929, 933 (9th Cir. 2008) (asserting that the government’s practice of sharing information with the DOJ was not unconstitutional and that the government is free to conduct “simultaneous criminal and civil investigations...”).
testify before the Commission.\textsuperscript{62} and it informs the subpoenaed witness that any information obtained may be used in a criminal proceeding.\textsuperscript{63}

Where both the DOJ and the Commission have filed concurrent actions, it is not unusual for the DOJ to request a stay of the civil proceeding to limit the criminal defendant’s discovery opportunities.\textsuperscript{64} The DOJ’s objective in requesting a motion to stay is to protect its witnesses from exposure to broad civil discovery.\textsuperscript{65} Under Rule 26 of the Federal Rules of Civil Procedure, a party must provide to the opposing party the name, address, and telephone number of each witness they intend to use, as well as identify each exhibit the party plans to use at trial.\textsuperscript{66}

\textbf{D. Chevron Deference}

In 1984, the Supreme Court decided a milestone administrative law case, \textit{Chevron U.S.A., Inc. v. Natural Resources Defense Council Inc.}, where it held that a court owes deference to an executive agency’s interpretation of a statute.\textsuperscript{67} The Supreme Court enunciated its analysis that must be applied when reviewing such an interpretation. Specifically, if Congress has unambiguously spoken on the issue, both the court and the agency must “give effect to the unambiguously expressed intent of Congress.”\textsuperscript{68} The Supreme Court went on to state that, “if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the

\textsuperscript{62.} Division of Enforcement Manual, supra note 50, at 43 (explaining that when requesting documents or information, the SEC lawyers must provide the witness with the 1662 form); see also Stringer, 535 F.3d at 934 (stating that Form 1662 is “[a] form sent to all witnesses subpoenaed to testify before the SEC”).


\textsuperscript{64.} See Walter P. Loughlin, Parallel Civil and Criminal Proceedings, 22 THE PRACTICAL LITIGATOR 19, 22–23 (Mar. 2011), http://www.klgates.com/files/Publication/780dc44c-a3af-4b60-8ce6-bbb6b913fed5/Presentation/PublicationAttachment/bdd1c1f9-2f07-4d57-b38c-b3c142e589b/Loughlin_PracticalLitigator_March2011.pdf (“A parallel civil and criminal case can be an avenue for civil discovery that is not available in the criminal case, a fact which often prompts a prosecution application for a stay of the civil case so as to protect its witnesses from exposure to civil discovery.”).

\textsuperscript{65.} \textit{Id.; see also} SEC v. Saad, 229 F.R.D. 90, 92 (S.D.N.Y. 2005) (denying the Government’s motion to stay the civil case pending resolution of the criminal action. Judge Rakoff rejected concerns that defendants would use civil discovery to “special advantage,” noting that the DOJ elected to coordinate the filing of its indictment with the SEC’s civil action).


\textsuperscript{68.} \textit{Id.} at 842–43.
agency's answer is based on a permissible construction of the statute. It stressed that legislative regulations should be given deference unless they are "arbitrary, capricious, or manifestly contrary to the statute." Although this was not the first case that imposed agency deference, it was the first case to expressly approve agencies' power to fill in gaps in statutory language, giving executive agencies power to use regulations to define statutory liability when intended.

The *Chevron* holding required judicial deference to agency regulations that are not unreasonable, a holding that conflicts with the rule of lenity. The Supreme Court addressed this tension initially in *Crandon v. United States*, a civil suit based on a criminal statute. It resolved the statutory ambiguity using the rule of lenity and held that "legislatures, not courts, define criminal liability." Five years later, the Supreme Court appeared to change direction in *Babbitt v. Sweet Home Chapter, Communities for Great Ore*, a civil case brought under an Environmental Protection Agency statute capable of both civil and criminal applications. In *Babbitt*, the Supreme Court stated that it has "never suggested that the rule of lenity should provide the standard for reviewing facial challenges to administrative regulations . . . ."

Most recently, in *Leocal v. Ashcroft*, the Supreme Court reversed a
ruling brought under a statute capable of both civil and criminal enforcement, applying the rule of lenity. It held that any statutory ambiguity had to be interpreted in the petitioner’s favor to ensure consistent interpretation. As Crandon, Leocal, and Babbitt illustrate, the Supreme Court has inconsistently applied the rule of lenity. However, unlike the rule of lenity, the Supreme Court has consistently applied the Commission’s rules in both civil and criminal cases, holding in SEC v. Zandford that the Commission’s interpretation of Section 10(b) was entitled to deference.

It is not always clear when Chevron should actually apply. Chevron deference allows executive agencies to construe statutory language and to clarify a law, power that can infringe upon the courts’ role. As Justice Marshall famously said, “It is emphatically the province and duty of the judicial department to say what the law is.” Chevron’s portrayal of administrative agencies as experts bestows upon these agencies the power to articulate new policy by devising schemes through promulgating their own rules.

79. Leocal v. Ashcroft, 543 U.S. 1, 11 n.8 (2004) (explaining that, even though the statute was being considered in Leocal’s case in the civil context of deportation, it was a statute that had both criminal and civil applications, so the rule of lenity needed to be applied to ensure consistency).

80. See supra notes 75–79 (stating that Crandon read a statute capable of both criminal and civil enforcement in favor of the defendant using the rule of lenity. Babbitt did not implement the rule of lenity when interpreting a statute capable of both criminal enforcement and instead deferred to the administrative regulation. Leocal held that the rule of lenity needed to apply to a statute in both its criminal and non-criminal contexts to ensure consistency.).

81. SEC v. Zandford, 535 U.S. 813, 819–20 (2002) (holding that Section 10(b) has always been interpreted flexibly and that the SEC’s consistent and broad interpretation of Section 10(b) should be entitled to deference because it is reasonable).

82. Patricia G. Chapman, Has the Chevron Doctrine Run Out of Gas? Senza Ripieni Use of Chevron Deference or the Rule of Lenity, 19 Miss. C. L. REV. 115, 117 (1998) (“[N]o consistent ‘deference’ guidelines have been articulated by the Supreme Court for other courts that must review agency interpretive activities.”).


84. See Sanford N. Greenberg, Who Says It’s A Crime?: Chevron Deference To Agency Interpretations Of Regulatory Statutes That Create Criminal Liability, 58 U. PITT. L. REV. 1, 9 (1996) (clarifying the principle of Chevron that courts should defer to administrators, and that administrator’s expertise “gives executive agencies the power to resolve ambiguous policy objectives in legislation”).
E. Federal Court’s Adoption of Deference to Rule 10b-5 in Insider Trading Cases

1. The Classical Theory of Insider Trading: Disclose or Abstain

A discussion of deference to the Commission’s rules begins with In re Cady, Roberts & Co. ("Cady Roberts"), an administrative proceeding that established the Commission’s standard of corporate insiders having a duty to disclose material information85 or, alternatively, abstain from trading.86 One of the first cases to adopt the Commission’s reasoning in Cady Roberts was SEC v. Texas Gulf Sulphur, Inc. ("Texas Gulf").87 In Texas Gulf, the Second Circuit held that any person in possession of material nonpublic information—not just officers and directors—must either disclose it to the investing public or abstain from trading on the material nonpublic information.88

Nineteen years after Cady Roberts was decided, in Chiarella v. United States, the Supreme Court endorsed the Commission’s holding in Cady Roberts.89 Although the Court held that insider trading liability under Rule 10b-5 “[w]as premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to the transaction,”90 there was no such duty between Chiarella and the shareholders of the companies in whose stock he traded because the shareholders had not placed their trust and confidence in Chiarella.91 When both Texas Gulf and Chiarella were decided, Rule 10b-5 was the only Commission Rule promulgated under Section 10(b) that reached insider trading.92

In 2008, eight years after the Commission had promulgated Rules 10b5-1 and 10b5-2,93 the Second Circuit decided United States v. Royer.94 In Royer, a criminal case, the Court held that a defendant commits insider trading in violation of Section 10(b) when he trades “‘while in knowing possession of nonpublic information material to those trades.’”95 Royer’s...
holding was based in part on deference to Rule 10b5-1, which defines insider trading as a manipulative and deceptive device within the meaning of Section 10(b) and incorporates an awareness standard for insider trading liability under Section 10(b). 96

2. The Misappropriation Theory of Insider Trading

“Rule 10b5-2 addresses misappropriation of ‘material nonpublic information . . . in breach of a duty of trust or confidence.’” 97 Rule 10b5-2 delineates the circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory. 98

Three years after the Supreme Court, in Chiarella, held that a corporate outsider did not owe a fiduciary duty to a company’s shareholders 99 and seventeen years before the Commission promulgated Rule 10b5-2, the Court decided Dirks. 100 In Dirks, the Court held that a tippee inherits the duty of the insider not to trade on material nonpublic information “[o]nly when the insider [tipper] has breached his fiduciary duty to the shareholders by disclosing the information and the tippee knows or should know that there has been a breach.” 101 A breach is determined by whether a financial “benefit” has been obtained. 102 In Dirks, the Court did not defer to the Commission’s interpretation of Rule 10b-5. 103

United States v. O’Hagan, decided in 1997, explicitly addressed the misappropriation theory and held that a person can be liable for insider trading under Rule 10b-5 “[w]hen he misappropriates confidential

96. See id. ("[T]he SEC . . . enacted Rule 10b5–1, adopting a knowing possession standard, and that determination is itself entitled to deference."); see also United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993) (holding that the “knowing” possession standard promulgated by the Commission is entitled to consideration and comports with the disclose or abstain rule from Chiarella).
97. 17 C.F.R. § 240.10b5-2(a).
98. Id. § 240.10b5-2(b) (“For purposes of this section, a ‘duty of trust or confidence’ exists . . . : (1) Whenever a person agrees to maintain information in confidence; (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history . . . of sharing confidences . . . ; or (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling . . . ”).
99. Chiarella v. United States, 445 U.S. 222, 232–33 (holding that, as a corporate outsider, Chiarella did not owe a fiduciary duty to the target company’s shareholders because they did not place their “trust and confidence” in him).
100. See supra note 15.
102. Id. at 663.
103. Id. at 647 (explaining that the SEC’s position “rests on the erroneous theory that the antifraud provisions require equal information among all traders. A duty to disclose arises from the relationship between parties and not merely from one’s ability to acquire information because of his position in the market.”).
information for securities trading purposes, in breach of a duty owed to the source of the information.\textsuperscript{104}

II. \textit{Newman}'s Implicit Adoption of Lenity and What It Portends for the Commission

A. Adopting Lenity in DOJ's Criminal Proceedings

In a criminal insider trading case, deference to the Commission’s interpretation of Rule 10b-5 conflicts with the rule of lenity.\textsuperscript{105} The rule of lenity requires that 1) defendants be put on notice about the elements that constitute a crime and that 2) legislatures, not courts, should define criminal activity.\textsuperscript{106} Therefore, a significant result of deference to agency interpretation is that new crimes can be defined by executive agencies,\textsuperscript{107} a power that traditionally rests solely with the legislative branch.\textsuperscript{108}

1. The Legislative Power to Define Crimes

As a civil agency, the Commission cannot bring criminal prosecutions.\textsuperscript{109} However, when \textit{Chevron} deference is given to an executive agency’s interpretation of a law that is capable of both civil and criminal enforcement, there is an insinuation of a civil agency’s rulemaking into criminal proceedings that raises due process issues. Specifically, it raises the concern “that laws which regulate persons or entities in society must give fair notice of conduct that is forbidden or required.”\textsuperscript{10} The due


\textsuperscript{105} Whitman v. United States, 135 S. Ct. 352, 353 (2014) (explaining the fundamental notion of lenity is to resolve a statutory ambiguity in favor of the defendant).

\textsuperscript{106} United States v. Bass, 404 U.S. 336, 348 (1971) (asserting that the rule of lenity is necessary to give “fair warning” to defendants concerning criminal liability, and because criminal liability can result in loss of freedom and “condemnation of the community,” it should be defined by the legislature).

\textsuperscript{107} See Whitman, 135 U.S. at 353 (contending that deference to an executive agency’s rule promulgation of a statute contemplating criminal liability allows that agency to ultimately define crime).

\textsuperscript{108} Id. ("[L]egislatures not executive officers define crimes [. . . ] Undoubtedly Congress may make it a crime to violate a regulation, but it is quite a different matter for Congress to give agencies—let alone for us to presume that Congress gave agencies—power to resolve ambiguities in criminal legislation.").

\textsuperscript{109} See Division of Enforcement, supra note 35 (clarifying that the Division of Enforcement “conducts investigations into possible violations of the federal securities laws and prosecutes the Commission’s civil suits in the federal courts as well as its administrative proceedings”); see also Division of Enforcement Manual, supra note 50, at 104 (explaining that the Commission cannot bring criminal enforcement actions).

process clause of the Fifth Amendment requires this notice. Such a constitutional principal is at odds with what Justice Stevens articulated in *Chevron* when he reasoned that Congress could delegate to executive agencies the power to interpret statutory language when authorized and could promulgate rules that implement policy decisions. Agencies possess the power to create policy; however, when these agencies administer regulations that carry criminal sanctions, the agencies' actions remove the legislative branch's power to impose punishment rules. The legislative branch, and not the executive agencies, should be defining crimes and ordaining the associated punishments.

*Chevron* deference is not unconstitutional, and the specificity with which executive agencies interpret statutory language that contemplates both criminal and civil enforcement is important. However, there is a line between interpreting an ambiguity and creating a new crime, and a common argument for deferring to an agency's promulgation of a rule, its expertise on the issue at hand, falls flat when that expertise is used to determine what conduct merits criminal punishment. Executive agencies carry out executive functions; because the executive branch does not give executive agencies the power to "[assess] the societal mores underlying criminal law [. . . .] The policies supporting special treatment for all criminal rules outweigh any remaining vitality of the *Chevron* policies. *Chevron* thus has no place in the review of administrative crimes." The application of the rule of lenity will benefit defendants of criminal insider trading prosecutions brought under Rule 10b-5; therefore, a uniform basis for criminal liability under Rule 10b-5 could help resolve the current federal circuit split on what behavior constitutes criminal liability.

111. See id. (citing United States v. Williams, 553 U.S. 285, 304 (2008)).
113. See *United States v. Wiltberger*, 18 U.S. 76, 95 (1820).
114. See *Greenberg*, supra note 84, at 17 (conceding that courts expect agencies to fill in gaps because it is unrealistic to assume Congress can predict every possible "ramification" of a law).
115. Mark D. Alexander, Note, *Increased Judicial Scrutiny for the Administrative Crime*, 77 CORNELL L. REV. 612, 622 (1992) ("The expertise theory of administrative agencies is problematic when used to resolve any value judgment, but is particularly difficult when the determination of societal mores is at issue. Agencies have no expertise to determine what conduct deserves the criminal penalty.").
116. Id. at 646.
117. Compare *United States v. Newman*, 773 F.3d 438, 447–48, 452 (2d. Cir. 2014) (holding that the personal benefit standard requires "proof of a meaningfully close personal relationship" between the tipper and tippee that results in an "objective" and "consequential" exchange with "potential" economic value), with *United States v. Salman*, 792 F.3d 1087, 1093-94 (9th Cir. 2015) (holding that a personal benefit is satisfied pursuant to *Dirks* when an insider discloses nonpublic material information to
Furthermore, achieving clarity and consistency in the elements of a criminal insider trading case brought under Rule 10b-5 will satisfy the fair notice requirement of due process.\textsuperscript{118} Although the Second Circuit in \textit{Newman} did not explicitly discuss \textit{Chevron} or the rule of lenity, the balancing of those two competing notions is implicit in the Second Circuit's holding that liability should only be imposed under Rule 10b5-2 if the government proves the tipper breached a fiduciary duty by receiving a personal benefit that went beyond mere friendship and that the tippee knew about the breach of the fiduciary duty.\textsuperscript{119} This standard expanded the language initially articulated in \textit{Dirks}, a case decided before the promulgation of Rule 10b5-2 or \textit{Chevron}.\textsuperscript{120}

\textbf{2. Judicial Adoption of the Rule of Lenity}

The Supreme Court has analyzed the tension between the \textit{Chevron} deference and the rule of lenity since the \textit{Chevron} decision in 1984.\textsuperscript{121} \textit{Crandon v. United States}, decided in 1990, was a civil suit based on 18 U.S.C. § 209(a), which criminalizes payment by a private party—and receipt by a government employee—of “[s]upplemental compensation for the employee’s government service.”\textsuperscript{122} Concerning the meaning of the statute, the Supreme Court held that, because the “[g]overning standard is set forth in a criminal statute, it is appropriate to apply the rule of lenity in resolving any ambiguity in the ambit of the statute’s coverage.”\textsuperscript{123} The Supreme Court ultimately interpreted the statute’s ambiguity in favor of the petitioners.\textsuperscript{124}

Justice Scalia’s concurrence in \textit{Crandon} addressed the notion of deference to the government’s interpretation of a criminal statute:


\textsuperscript{119} \textit{Newman}, 773 F.3d at 447–48, 452.

\textsuperscript{120} See \textit{Dirks} v. SEC, 463 U.S. 646, 662 (1983) (explaining that, when an insider discloses material inside information, it is only a breach of fiduciary duty when that insider receives some sort of personal benefit or gain).

\textsuperscript{121} See \textit{Greenfield}, supra note 74, at 38–40 (“Although the Supreme Court has not yet decided how a conflict between \textit{Chevron} deference and the rule of lenity should be resolved, it has briefly discussed the issue in \textit{Crandon v. United States}, 494 U.S. 152 (1990) and \textit{Babbitt v. Sweet Home Chapter, Cmtys. for a Great Or.}, 515 U.S. 687 (1995)).”)


\textsuperscript{123} \textit{Id.} at 158.

\textsuperscript{124} \textit{Id.} at 168 (“To the extent that any ambiguity over the temporal scope of [the statute] remains, it should be resolved in the petitioners’ favor unless and until Congress plainly states that its intent has been misconstrued.”).
The law in question, a criminal statute, is not administered by any agency but by the courts. [ . . . ] The Justice Department, of course, has a very specific responsibility to determine for itself what this statute means, in order to decide when to prosecute; but we have never thought that the interpretation of those charged with prosecuting criminal statutes is entitled to deference. 125

Justice Scalia wrote another dissent, five years later, in Babbitt. Babbitt was an environmental law case where the Supreme Court affirmed the Secretary of the Interior’s promulgation of a rule defining “harm” under the Endangered Species Act of 1973, a law that had both criminal and civil applications.126 The Supreme Court did not apply the rule of lenity, stating that it had “never suggested that the rule of lenity should provide the standard for reviewing facial challenges to administrative regulations whenever the governing statute authorizes criminal enforcement.”127 In Whitman, Justice Scalia recalled that the Supreme Court in Babbitt deferred “with scarcely any explanation, to an agency’s interpretation of a law that carried criminal penalties.”128 Justice Scalia expressed his continued disagreement with this outcome, as it controverted previous federal court decisions which held that if a law was capable of both criminal and civil enforcement then the rule of lenity should apply in both the criminal and civil proceedings.129

In 2004, in Leocal, the petitioner, a lawful permanent resident of the United States, violated Florida law when he was convicted of driving under the influence of alcohol (“DUI”) and of causing serious bodily injury in an accident.130 An Immigration Judge and the Board of Immigration Appeals classified the conviction under 18 U.S.C. § 16 and ordered the petitioner to be deported.131 The Supreme Court reversed the conviction.132 Although the pertinent statute was used in a noncriminal context (for deportation), the statute had both criminal and civil applications.133 This dual application permitted the Court to apply the rule of lenity and interpret any statutory

125. Id. at 177 (Scalia, J., concurring).
126. See Babbitt v. Sweet Home Chapter of Cmty. for a Great Or., 515 U.S. 687, 696 n.9 (1995) (clarifying that the Secretary of the Interior’s definition of the harm under 50 C.F.R. § 17.3 (1994) “is limited to ‘act[s] which actually kill[ ] or injur[ ] wildlife’” and that one must knowingly violate the Endangered Species Act to be subject to criminal or severe civil liability).
129. See id. at 353–54 (contending that the Babbitt Court’s refusal to apply lenity goes against case precedent that clearly states if a law is capable of both civil and criminal applications, the rule of lenity “governs its interpretation in both settings”).
131. Id.
132. Id. at 13.
133. Id. at 11 n.8.
ambiguity in Leocal's favor to ensure consistent interpretation.\footnote{134}{See id. (holding that Leocal's DUI could not be found to be a crime of violence under section 16, under the principle that any ambiguity in the statute must be resolved in Leocal's favor).}

\section*{B. Applying the Rule of Lenity in the Commission's Civil Proceedings}

The cases presented in the previous section, unlike \textit{Newman}, were civil cases, yet the Supreme Court applied the rule of lenity in both \textit{Crandon} and \textit{Leocal} because the statutes at issue were capable of both criminal and civil applications. Applying the rule of lenity to civil enforcement actions potentially will impede the SEC's robust enforcement initiatives under the Commission's Chairwoman, Mary Jo White.\footnote{135}{SEC Biography: Chair Mary Jo White, SEC, http://www.sec.gov/about/commissioner/white.html#.VQ8aV2TF_Ck (last updated July 23, 2013).} Chairwoman White has been vocal in advocating a "broken windows" approach to enforcement, holding that no violation is too small to pursue.\footnote{136}{See White, supra note 45 ("[M]inor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines. And so, I believe it is important to pursue even the smallest infractions. Retail investors, in particular, need to be protected from unscrupulous advisers and brokers, whatever their size and the size of the violation that victimizes the investor.").}

However, SEC Commissioner Michael Piwowar has expressed skepticism about the broken windows enforcement policy, suggesting that its zero-tolerance policy ultimately harms the Commission's regulatory role.\footnote{137}{See Michael S. Piwowar, Commissioner, SEC, Remarks to the Securities Enforcement Forum 2014 (Oct. 14, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543156675 (explaining that the Commission's mission is to have a strong capital market, not solely to achieve regulatory compliance).} Commissioner Piwowar noted that by adopting a broken windows approach to enforcement actions, the Commission's mission becomes diluted; "If you create an environment in which regulatory compliance is the most important objective for market participants, then we will have lost sight of the underlying purpose for having regulation in the first place."\footnote{138}{Id.}

The Commission's administrative power further increased with the 2010 implementation of Dodd-Frank, granting the Commission power to impose civil penalties. These were penalties the Commission could previously seek only in federal court: in administrative cease-and-desist proceedings brought under violations of the Securities Act and the Securities Exchange Act.\footnote{139}{Dodd-Frank Act, Pub. L. No. 111-203, § 929P(a), 124 Stat. 1802, 1862 (2010).} Dodd-Frank also expanded the reach of the Commission by allowing it to bring administrative actions against any unregistered
individual.\textsuperscript{140} With these increased powers, administrative proceedings have become the Commission’s forum of choice for insider trading actions.\textsuperscript{141}

The Commission has distinct advantages in its administrative forum.\textsuperscript{142} Along with being tried by a Commission-appointed administrative law judge,\textsuperscript{143} administrative proceedings differ in important ways from those of a federal court: 1) the proceedings are limited in their discovery process, most notably in that a defendant cannot conduct discovery depositions; 2) the out of court investigation testimony of the Commission is freely admitted; and 3) there is no right to a trial by jury in an administrative proceeding.\textsuperscript{144}

Dodd-Frank expands the Commission’s administrative enforcement power through Section 929P(a), which enables the Commission to obtain virtually everything it could obtain through federal court proceedings through internal administrative proceedings.\textsuperscript{145} These increased enforcement powers, along with the implicit adoption of lenity in \textit{Newman}, may prompt the Commission to move its insider trading cases to the administrative forum.\textsuperscript{146} In an administrative proceeding, federal courts

\textsuperscript{140} \textit{Id.}


\textsuperscript{142} \textit{See} Andrew Ceresney, Director, SEC Division of Enforcement, Remarks to the American Bar Association’s Business Law Section Fall Meeting (Nov. 14, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VQ3AEmTF_Ck (“First, administrative actions produce prompt decisions. […] Second, administrative proceedings have the benefit of specialized factfinders [sic]. […] Third, the rules governing administrative hearings provide that ALJs should consider relevant evidence. In practice, what this means is that ALJs are guided by, but not obligated to strictly apply, the Federal Rules of Evidence.”).

\textsuperscript{143} \textit{See} 15 U.S.C. § 78d-l(a) (2015) (“The [SEC] shall have the authority to delegate . . . any of its functions to a division of the Commission, an individual Commissioner, an administrative law judge . . . including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter.”).


\textsuperscript{146} \textit{See id.} at 7, 9–10 (explaining that, given the expansion of administrative powers by Dodd-Frank and the Commission’s hope to avoid defeat in federal courts, the Commission may begin bringing cases in administrative proceedings).
give an administrative law judge's decision deference, so an administrative judge effectively makes the law. If the rule of lenity applied to both criminal prosecutions and civil administrative proceedings, the Commission would lose a key advantage of bringing enforcement actions in its administrative forum because courts would no longer give these administrative actions *Chevron* deference.

C. Limiting the Rule of Lenity to DOJ's Criminal Proceedings

In *Newman*, as in any criminal case, the Government needed to prove each element of the offense beyond a reasonable doubt. Furthermore, the Government was obligated to prove that the defendant committed the violations "willfully," a more advanced mental state than the awareness standard the Commission must meet in civil cases brought under Rule 10b5-1. The application of both *Chevron* deference and the rule of lenity requires a statutory ambiguity to be applied. The statutory ambiguities identified by the Second Circuit in *Newman* were resolved in favor of Newman, and the Court implicitly applied the rule of lenity in two ways. First, it resolved the statutory ambiguity regarding the tippee's mental requirement of knowledge, and it explicitly held that the tippee must have knowledge of both the tipper's breach of fiduciary duty and the tipper's personal benefit. Second, the Court went further than *Dirks* and resolved the ambiguity of what a personal benefit actually is, a standard first articulated in *Dirks*. The Court held in *Newman* that mere friendship

147. *Id.* at 10.
148. *See id.* (explaining that an administrative law judge's ruling on an "undecided issue of statutory interpretation of the securities law is, just like rules enacted by the Commission, entitled to 'Chevron' deference").
149. *See supra* notes 54–57 (noting the Commission, as a civil agency, is held by the courts to a preponderance of the evidence standard of proof, whereas DOJ is held to a beyond a reasonable doubt standard).
150. *See supra* note 59.
151. Compare United States v. Newman, 773 F.3d 438, 450 (2d. Cir. 2014) (holding explicitly that a tippee's insider trading liability is predicated on the tippee's knowledge of both the tipper's breach of fiduciary duty and the tipper's receipt of a personal benefit), with *Dirks* v. SEC, 463 U.S. 646, 660-62 (1983) (holding that liability shall be imposed when the tippee knows there has been a breach of fiduciary duty. The tippee's knowledge of the tipper's personal benefit is implicit because whether a tipper has breached his fiduciary duty hinges on whether he will personally benefit from the tip.).
152. *Newman*, 773 F.3d at 452 (articulating a specific personal benefit standard, namely a relationship that is significant and results in a "consequential" exchange with "potential" economic value).
153. *Dirks*, 463 U.S. at 663 ("[T]he initial inquiry is whether there has been a breach of duty by the insider [ . . . ] *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational
between the tipper and the tippee is not enough to establish a personal benefit.\textsuperscript{154}

It is only necessary to apply the rule of lenity to a criminal proceeding for insider trading violations. If all of the insider trading violation elements articulated in \textit{Newman} are proven, then the conviction would subsume the preponderance of the evidence standard the Commission would be required to prove in a civil proceeding: a proceeding that would have likely been stayed pending the outcome of the criminal proceeding.\textsuperscript{155} However, if the government cannot prove the elements beyond a reasonable doubt in a criminal proceeding, a district court judge or an administrative law judge could then appropriately apply \textit{Chevron} deference to the Commission’s rule promulgations. The Commission would need to prove each element by a preponderance of the evidence standard in a civil proceeding.\textsuperscript{156}

Andrew Ceresney, Director of the SEC Enforcement Division, has publicly stated that \textit{Newman} is not likely to inhibit the Commission’s pursuit of insider trading cases.\textsuperscript{157} However, \textit{Newman} has affected administrative proceedings as well as district court decisions. In February 2015, Administrative Law Judge Jason Patil ordered the Commission to show that the respondent in an administrative proceeding had received a significant personal benefit that went beyond mere friendship in exchange for tipping a trader with material inside information.\textsuperscript{158} In the Southern District of New York, myriad defendants cited the \textit{Newman} ruling in various applications for review in criminal proceedings brought by DOJ.\textsuperscript{159}

\textsuperscript{154} \textit{Newman}, 773 F.3d at 452 (holding that if the Government were allowed to meet its burden by proving two people by the mere fact of friendship, the requirement would be a “nullity”).

\textsuperscript{155} \textit{See} Loughlin, \textit{supra} note 64, at 22–23 (explaining that DOJ frequently requests a stay in the civil proceedings to protect its witnesses from broad civil discovery).

\textsuperscript{156} \textit{See} Steadman v. SEC, 450 U.S. 91, 103 (1981) (holding that Congress intended that the Commission’s proceedings should be governed by a preponderance of the evidence standard subject to § 7 of the Administrative Procedure Act).

\textsuperscript{157} Stephanie Russell-Kraft, \textit{SEC’s Ceresney Isn’t Sweating 2nd Circ.’s Newman Ruling}, \textit{LAW360} (Feb. 10, 2015, 6:10 PM), http://www.law360.com/articles/620472/sec-s-ceseysy-isn-t-sweating-2nd-circ-s-newman-ruling (reporting that Mr. Ceresney’s statement at a Practicing Law Institute event that \textit{Newman} is not likely to change the Commission’s approach to insider trading cases involving tippee liability because the Commission is subject to a lower burden of proof and has the ability to bring actions in other forums).


\textsuperscript{159} Max Stendahl, \textit{Bharara Foes Pounce on Newman Ruling in SDNY}, \textit{LAW360} (Feb. 13, 2015, 4:42 PM), http://www.law360.com/articles/620971/bharara-foes-
Attorney for the Southern District of New York, Preet Bharara, raised concerns about the impact of *Newman* in his petition for a rehearing en banc following the *Newman* ruling, as well as the Commission’s subsequent amicus brief in support of the petition. The petition for rehearing contended that *Newman* “b[reaks] with Supreme Court and Second Circuit precedent, conflicts with the decisions of other circuits, and threatens the effective enforcement of the securities laws . . . [by] engender[ing] confusion among market participants, parties, judges, and juries.” The petition noted that *Newman*’s definition of personal benefit is inconsistent with the Supreme Court’s holding in *Dirks*. As for the impact on investors, the petition noted that *Newman*’s holding put in jeopardy the Commission’s ability to continue its robust enforcement of insider trading violations, a bulwark of its primary mission of protecting investors.

The Second Circuit denied the petition for rehearing en banc on April 3, 2015. On July 30, 2015, the Government filed a petition for writ of certiorari in the Supreme Court. The petition presented and asked the Court to resolve a narrow issue: whether insider trading liability under the misappropriation theory requires that the personal benefit the tipper receives be a product of a “meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”


163. Id. at 13-14 (explaining that the Second Circuit used the personal benefit language from *Dirks* but “upended” it in a way that was “inconsistent with *Dirks*”).

164. Id. at 23 (explaining as an example that *Newman*’s heightened personal benefit standard could permit tippers to reveal material inside information to a tippee and avoid liability “because the tipper ‘‘did not expect any pecuniary or ‘similar’ value in return’’”).


167. Id.
rejected *Dirks*’ holding that a personal benefit could be “inferred simply by a personal relationship between the tipper and the tippee.” On October 5, 2015, the petition for certiorari was denied by the Supreme Court.

In *United States v. Salman*, Judge Rakoff, sitting by designation, eschewed the Second Circuit’s holding in *Newman*. Instead, Judge Rakoff referred to *Dirks*, holding that proof of a personal benefit only requires “proof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend . . . .” Judge Rakoff, citing *Dirks*, held that a personal relationship between the tipper and the tippee satisfies the personal benefit element. Specifically, the Ninth Circuit held that a breach of fiduciary duty (and thus the tipper’s personal benefit) can be established when an insider discloses confidential information to someone with whom the insider has a personal relationship; no enhanced “tangible benefit” articulated by *Newman* is necessary to establish liability.

Due process requires that defendants be given fair notice as to what conduct could result in criminal liability. While varying court opinions interpreting Rule 10b-5, Rule 10b5-1, and Rule 10b5-2 are appropriate in the civil arena, criminal liability needs to be defined with more specificity to avoid “[r]andomly sacrificing individuals on the altar of investor confidence.” In *Newman*, the Second Circuit ultimately used language that resolved the ambiguity in Rule 10b-5 in favor of the defendant. Although the Second Circuit did not explicitly invoke the

168. *Id.* at 452.


170. United States v. Salman, 792 F.3d 1087, 1094 (9th Cir. 2015).

171. *Id.* at 1093 (declining to apply *Newman*’s personal benefit standard and holding instead that a personal benefit is satisfied pursuant to *Dirks* when an insider discloses nonpublic material information to a “relative or friend”).

172. *Id.* (“[The Defendant] argues that because there is no evidence that [the tipper] received any such tangible benefit in exchange for the inside information, or that [the Defendant] knew of any such benefit, the Government failed to carry its burden. To the extent *Newman* can be read to go so far, we decline to follow it.”).

173. See Bach Hang, *The SEC’s Criminal Rulemaking in Rule 10b5-2: Incarceration Should Be Made of Sterner Stuff*, 41 WASHBURN L.J. 629, 653 (2002) (explaining that due process requires defendants to be on notice of what behavior constitutes as criminal and could therefore lead to imprisonment).

174. *Id.* (arguing that developing the misappropriation theory on individualized facts may be appropriate in the civil arena but determining criminal liability on an “ill-defined” definition can have negative repercussions).

175. *Id.*

176. United States v. Newman, 773 F.3d 438, 452 (2d. Cir. 2014) (rejecting the Government’s argument and holding that the tippee’s knowledge of both the breach of fiduciary duty and of the personal benefit is necessary to impose criminal liability).
rule of lenity, *Chevron* deference, or mention *Whitman* in its holding, the Second Circuit’s reasoning reconciles each of these principles implicitly in its language and ruling in favor of Newman.\(^{177}\) This implicit judicial adoption of the rule of lenity in a criminal proceeding rejects the Commission’s interpretation of insider trading rules. *Newman*, by defining criminal liability with clear and specific language, performs its judicial function of interpreting Congress’ language in Section 10(b) of the Exchange Act.\(^{178}\) Ultimately, this clear language protects investors and bolsters their confidence in participating in a federal securities market that does not impose arbitrary standards for criminal liability.

D. The Circuit’s Differing Interpretations of Dirks and the Supreme Court’s Denial of Certiorari

In *Newman*, the Second Circuit went beyond the “trading relative or friend” language used by the *Dirks* court\(^{179}\) and defined personal benefit with specificity.\(^{180}\) *Salman*, in contrast, held that since the defendant had received an insider trading tip from someone considered a “relative or friend,” that was sufficient to establish liability.\(^{181}\) Newman argued in his brief in opposition to certiorari that *Newman’s* holding remains consistent with *Dirks*.\(^{182}\) Newman further argued that the Second Circuit appropriately used *Dirks’* language to articulate a more detailed standard of tipper liability that defines when a tipper’s disclosure results in a significant personal benefit.\(^{183}\) The Second Circuit’s language in *Newman* articulates a

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177. *See id.* at 447–48, 452 (resolving the ambiguity regarding the knowledge requirement of the tippee and what a personal benefit actually is by holding 1) that the tippee must know about both the tipper’s breach of fiduciary duty and his personal benefit, and 2) that the personal benefit requires proof of “a meaningfully close personal relationship” that results in an exchange with potential pecuniary value).


180. *See Newman*, 773 F.3d at 452 (articulating a heightened personal benefit standard requiring a relationship that goes beyond mere friendship and that results in an exchange with potential economic value).


182. *See Brief for Todd Newman in Opposition at 21, United States v. Newman 773 F.3d 438 (2d. Cir. 2014) (No. 15-137)* (explaining that the Second Circuit acknowledged and used the relevant personal benefit language first articulated in *Dirks* when defining liability in *Newman)*.

183. *See Newman*, 773 F.3d at 452 (noting that, in circumstances where there is a close personal relationship between the tippee and the tipper that is meaningful, significant, and goes beyond “mere friendship,” a reasonable inference of a personal
specific standard that market participants will know has potential criminal implications.\textsuperscript{184}

The petition presented a narrow issue for the Supreme Court to consider: whether \textit{Newman}'s personal benefit holding contravened \textit{Dirks}.\textsuperscript{185} The broader issue of \textit{Chevron} deference was not raised in the Government's petition for certiorari. On October 5, 2015, the petition for certiorari was denied.\textsuperscript{186} As is customary, the Supreme Court did not articulate a reason for this denial.\textsuperscript{187} It is possible the Supreme Court will take the opportunity to decide whether the rule of lenity trumps \textit{Chevron} deference when a more explicit presentation of the issue comes along. Justice Scalia, in his accompanying statement in \textit{Whitman}, has already sent a strong signal inviting a case that squarely presents the \textit{Chevron} issue.\textsuperscript{188}

\textbf{III. RECONCILING THE RULE OF LENITY WITH THE COMMISSION'S ENFORCEMENT POWER}

Lenity is a historical rule of criminal law that is based on due process principles of notice and the legislature's right to define crimes.\textsuperscript{189} The issue of whether the rule of lenity is required to be applied in the Commission's enforcement proceedings evokes a fundamental structure of the United States: the separation of powers.\textsuperscript{190} The legislative branch enacts the laws; the executive branch enforces the laws enacted by the legislative branch; and the judicial branch interprets the laws enacted by the legislative branch and the rules promulgated by the executive branch.\textsuperscript{191} Justice Scalia made

\begin{itemize}
\item \textsuperscript{184.} \textit{Id.} (contending that \textit{Newman}'s heightened personal benefit standard puts market participants on notice about whether they partake in a personal relationship that could "trigger an inference" of a personal benefit).
\item \textsuperscript{187.} \textit{Id.}
\item \textsuperscript{188.} \textit{See} Whitman v. United States, 135 S. Ct. 352, 354 (2014) ("But when a petition properly presenting the question [of deference to the Commission] comes before us, I will be receptive to granting it.").
\item \textsuperscript{189.} \textit{See} United States v. Bass, 404 U.S. 336, 348 (1971) (explaining that the rule of lenity is founded on two policies that have long been part of the Court's tradition: first, defendants have a right to fair notice about what the law is, and second, that legislatures should ultimately define crime).
\item \textsuperscript{190.} \textit{See} Greenfield, \textit{supra} note 74, at 12 ("The rule that penal laws are to be construed strictly . . . is founded . . . on the plain principle that the power of punishment is vested in the legislative, not in the judicial department. It is the legislature, not the Court, which is to define a crime, and ordain its punishment.").
\item \textsuperscript{191.} \textit{See} National Conference of State Legislatures, \textit{supra} note 178.
\end{itemize}
clear, in his statement accompanying the Court’s denial of certiorari in *Whitman*, that the executive branch has usurped the function of the legislative branch through its rulemaking authority and has enabled this usurpation by applying *Chevron* deference in criminal cases.\footnote{192. See *Whitman v. United States*, 135 U.S. 342, 353 (2014) (contending that legislatures rather than executive officers should articulate crimes and that judicial deference to executive rule promulgations where criminal liability is at stake allows the executive agency (rather than the legislature) to define criminal conduct).}

The Commission’s “mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation” is vital to ensuring a strong national market.\footnote{193. Atkins, *supra* note 37, at 369.} However, as part of the executive branch, the Commission is not empowered to define crimes.\footnote{194. *Whitman*, 135 U.S. at 353.} Using the rule of lenity in criminal prosecutions under Rule 10b-5, the promulgation of a rule of significant importance and of routine use could create a fair system that respects due process as well as the Commission’s expertise and mission of protecting investors. Applying the rule of lenity to every law that contemplates both criminal and administrative enforcement would have widespread ramifications, as many of the Commission’s laws contemplate both civil and criminal liability.\footnote{195. Martens, *Scalia’s Deference Argument Could Have Dramatic Effects*, *supra* note 3 (stating that adoption of Justice Scalia’s lenity argument in *Whitman* could extend to claims brought under the Securities Act, the Investment Company Act, the Investment Advisors Act, and the Foreign Corrupt Practices Act).}

Arguably, “[a court should not] interpose its own construction when the Commission’s expertise is more adept at dealing with the complex nature of mutual fund structures, market transactions, and unique or novel forms of fraud.”\footnote{196. Matthew P. Wynne, *Rule 10b-5(b) Enforcement Actions in Light of Janus: Making the Case for Agency Deference*, 81 FORDHAM L. REV. 2111, 2148 (2013).} The Commission is adept at dealing with the complex nature of the securities market, but the enforcement of criminal laws has never been a power delegated to the Commission. The rule of lenity is a standard of interpretation that should be used only when criminal penalties are at stake.\footnote{197. See Greenfield, *supra* note 74, at 60 (“The Chevron presumption, which opts for a blanket rule of deference over a case-by-case determination of whether Congress intended a particular result, is inappropriate where criminal penalties are at issue.”).}

To balance these conflicting interests, lenity should be applied in criminal proceedings only. This recommendation has proved feasible when using *Newman* as the framework. It is only necessary to apply the rule of lenity to a criminal proceeding for insider trading violations brought by the DOJ; if the government could obtain a conviction by proving beyond a reasonable doubt all of the insider trading violation elements articulated by
Newman, then that conviction would subsume the preponderance of the evidence standard the Commission is required to prove in a civil proceeding. However, if the Government could not prove the elements beyond a reasonable doubt, Chevron deference could then be appropriately applied to the Commission’s rule promulgations in a civil proceeding, and the Commission will be bound to prove each and every element by a preponderance of the evidence standard. Adopting the rule of lenity, rather than deferring to the Commission under Chevron in insider trading prosecutions, is ultimately a way to preserve a defendant’s due process rights while still ensuring that the Commission’s administrative powers are not stripped from the agency.

CONCLUSION

Justice Scalia’s voiced disapproval of applying Chevron deference in a criminal context, in conjunction with the Second Circuit’s holding in Newman, represents a judicial shift away from administrative deference when criminal liability is at stake under Rule 10b-5. The rule of lenity is appropriate only in criminal proceedings brought under Rule 10b-5. Due process principles need to be upheld by the defendant’s right to be informed of what constitutes criminal liability, and it is not within the Commission’s power to define criminal liability. It is important to allow the Commission to maintain its mission of protecting investors by allowing Chevron deference to the Commission’s interpretation of Rule 10b-5 only in civil proceedings when civil penalties are at stake. Ultimately, investors will benefit from more narrowly drawn rules, defining criminal conduct and allowing for more uniformity in judicial interpretation of the Commission’s rules.

198. See Loughlin, supra note 64, at 22–23 (explaining that DOJ prosecution frequently requests a stay of civil proceedings for discovery purposes).
199. See Steadman v. SEC, 450 U.S. 91, 103 (1981) (concluding that Congress intended the preponderance standard to apply in civil proceedings directed by the Commission).