

Securities and Exchange Commission Historical Society
Oral History Project
Interview with Frank Easterbrook
Conducted on January 13, 2011, by Kenneth Durr

KD: Interview with Frank Easterbrook, January 13th, 2011, in Chicago, Illinois, by Kenneth Durr. Let's start with your early influences. I want to talk a little bit about law school. You went to school here in Chicago. Was there a focus on securities law at the time?

FE: Quite the opposite. The professor of corporate and securities law at the University of Chicago when I was a student was Stanley Kaplan. Although Kaplan was an ALI insider on corporate projects, let's just say he was not an engaging teacher, nor was he an intellectual, by any means. It can be summed up in many ways.

When Kaplan began one corporate class by mentioning some case, he said, "Well, you know, that case reminds me. That corporation was organized in New York. One day when I was in New York, I was invited by Lenny Bernstein over to his place. You know, we were raising money for some cause, and what Lenny said to me was so-and-so," and then he would then go on, getting farther and farther away from the case, not honing in on any corporate problem. One day, he skipped class, and somebody else appeared to deal with it, and the word quickly went around the school that he had been hospitalized to have his anecdote removed. I took several weeks of his corporate class and then dropped out.

KD: So you had to pick a lot of that up on your own?

FE: There were a lot of other people at the law school, often including students, who were interested in economic analysis of law. And of course, Dick Posner, who same year I was trying unsuccessfully to take corporations from Stanley Kaplan, had produced the manuscript of the first edition of his *Economic Analysis of Law*, which had chapters on the economics of corporate law and the economics of securities law. There were other places to go if you were interested in a real intellectual analysis of what was going on, but Stanley Kaplan's class was not that place. In fact, that remained true when I decided to go into teaching after five years in the Solicitor General's office. Dick Posner was among those who particularly urged me to specialize in corporate and securities law because there hadn't been any really rigorous economic analysis of that.

KD: You mentioned Posner's manuscript. Was that floating around before it got published in '72, '74?

FE: Well, floating around, he used it as a basis of a seminar called *Economic Analysis of Law*, which I took.

KD: Let's get you into clerking in the First Circuit. How did that broaden your expertise? How did that turn you in the direction your career later took?

FE: There were actually very few economic cases in the First Circuit. I can't remember any securities or anti-trust cases of the smallest moment. Of course, I continued to read in

those fields, since I was definitely interested in economic analysis of law and thought that it was very likely I would ultimately end up in the academy. There was plenty of time to do reading when I was a clerk at the First Circuit because back then, this is 1973 to '74, the First Circuit had only three judges, the smallest size a circuit could be. But it didn't have enough work for three judges, so nobody stayed long hours. It really had three judges plus. It had, for a long time, had only three judges, and then Bailey Aldrich took senior status. Levin Campbell, for whom I clerked, was appointed to replace him, but Judge Aldrich continued hearing a lot of cases.

There were three-and-a-half, maybe three-and-three-quarters, judges available. Although it still surprised me, how often after losing a case before the panel of the three active judges, Chief Judge Coffin, Judge McEntee, and Judge Campbell, lawyers would file petitions for rehearing en banc. You kept scratching their head, saying, "Didn't you know your case has already been heard en banc?"

KD: How did you come to the Solicitor General's office?

FE: Bob Bork was appointed Solicitor General roughly at the beginning of my time as a law clerk. As somebody who was interested both in advocacy – I really like the process of appellate advocacy – it was clear I was either going to be a full-time appellate advocate or an academic, or maybe get a chance to do both. The opportunity to do a little of each, to work with a professor of law, which Bob Bork was in his past and would be again in his future, in a place that was doing interesting appellate advocacy was very attractive. If

you're interested in the process of being an appellate advocate, there is no better place than the Solicitor General's office. I went about it in the same, untutored way that anybody might; I sent in a letter saying, "Hi, I'd like to apply for a job at the Solicitor General's office."

KD: Didn't know anybody?

FE: Didn't know anybody, and they did something that was unexpected. These days, if anybody sent that letter, I think they get a form letter rejection saying, "We hire only people with lots of appellate practice. After you become a junior partner at a big law firm, get back in touch." But those days, I think all these letters from weird people were shown to the Solicitor General. Bob Bork got my letter. I gather that he picked up the phone and called some of his friends at the University of Chicago. I mean, after all, he's an academic. He knows a lot of people at Chicago. They said good things about me, and I got invited for an interview. Bob and I hit it off really well.

We hit it off particularly well because he asked me some of the things I was interested in. I said I was interested, in addition to economic analysis of law, in the intellectual history of the Supreme Court. He said, "There is not much that's intellectual about that history." I then launched into a critique of the *Holmes Devise History of the Supreme Court*. You can see on my shelf up here, the volumes of that that have ultimately been produced. I pointed out that I thought it was scandalous that although Holmes made his gift in his will, and the foundation to do this was set up in the fifties, there we were in either the fall

of '73 or the spring of '74, and there were only two volumes out. A bunch of people had promised to do volumes and hadn't done it.

Bork had also thought this was scandalous. So we hit it off very well. I was actually much taken with his opening move, which was to shake my hand and say, "Call me Bob." That's roughly what I do with my law clerk, have done with my law clerks ever since. I tell them, "Call me Frank." I think it promotes a good interchange.

KD: Well, talk about some of the issues that you started having that changed that, particularly in the securities line.

FE: I ended up staying for five years. I was an assistant to the Solicitor General for three-and-a-half years and Deputy Solicitor General for the last year-and-a-half. As deputy, my portfolio was essentially all miscellaneous civil litigation that included anti-trust and securities. In that period, everything related to securities crossed my desk. In the earlier years, securities cases came to me only if the deputy who was involved, and that could be either Dan Friedman for part of my time there or Keith Jones for part of my time there, brought me in on it because the initial assignments were made by the Deputy Solicitors General.

The first securities case that I was brought in on was *Blue Chip Stamps against Manor Drug Stores*. Let me check when we filed the brief in *Blue Chip Stamps*. It was in February 1975. I had been in the SG's office for maybe five months when we filed the

brief in *Blue Chip Stamps*. Do you know from earlier oral histories or other sources how the Solicitor General works with the SEC on securities cases?

KD: That's one of the things I want to talk to you about because I've heard it from the SEC's point of view.

FE: Well, I was just thinking of the physical process. When there is a securities case before the Supreme Court, the SG asks the SEC, which means, as a practical matter, their general counsel and their solicitor, whether we should be involved. If so, what should happen? And if they recommend that we participate, please send us a memo justifying participation and a draft. Well, that was done in *Blue Chip Stamps*. The SEC says let's participate because we want the Supreme Court to disapprove the Birnbaum Doctrine of the Second Circuit. Now of course, getting the Supreme Court to disapprove Learned Hand is never really easy, but we want the Supreme Court to disapprove the Birnbaum Doctrine.

The Solicitor General approved participation, and that draft ended up on my desk. At that point, the Solicitor General's office, the assistant will do some editing of the SEC's draft, and send it back to the SEC for comments. What happened in this case was that I looked at the SEC's draft, and I sent them back a completely different draft, just totally different draft. Apparently, a lot of people went through the roof over at the SEC and thought they were not getting enough respect. Who was this Easterbrook person anyway? They had never heard of him. The next thing I know, I got a delegation in my

office of Commissioner Loomis, and the general counsel, and of course Dave Ferber, who was there as solicitor the whole time I was in the SG's office, and a lot of time before and after. I think Dave Ferber once argued a case to me after I'd become a judge. Commissioner Loomis and Dave Ferber were the institutional memories of that place.

You need to understand what had happened. They had sent me a draft over, which said, "Dear Supreme Court, we are the SEC. You are becoming sleepy. Pay attention to what we say. You are becoming sleepy. Now that you're asleep, just remember that ever since *J. I. Case against Borak*, everything you've been doing was to improve the enforcement of the securities laws. And just like *J. I. Case against Borak*, you can do more to improve the enforcement of the securities. You are becoming sleepy."

KD: It wasn't a compelling document.

FE: It basically said, "We're the SEC. We want you to hold that these things are allowed. Yours sincerely, the SEC." Now, they may have filed briefs like that in the past. I didn't go back and research the history of SEC briefs in securities cases. They may have filed briefs like that in the past, and that may have been successful. But they seemed to have missed the fact that Lewis Powell had been appointed to the Supreme Court in the interim, and he had been a securities lawyer. He cared a lot about these things. They may actually have missed the fact that Thurgood Marshall had been appointed to the Supreme Court in the interim. Thurgood Marshall was not a securities lawyer, but

Thurgood Marshall knew that if the Second Circuit had taken a position on a matter of securities law, he wanted to support that.

I thought the “We are the SEC” approach was not going to be successful with the contemporary Supreme Court. Well, their delegation came over. I wrote a brief that said, “Look, we’ve got some linguistic reasons for thinking that statements in *Blue Chip Stamps*, which are statements designed to lead certain people who had rights under a consent decree not to purchase the stock, to lead them not to purchase the stock, were actually in connection with the purchaser sale of the stock even though the plaintiffs didn’t buy.”

That technical argument was what was going on. What the defendants had done was make negative statements to our plaintiffs, so that the amount of stock they were going to sell, which had already been prescribed in the consent decree, would go to a different set of people. It was in connection with the purchase by group B, and they got the purchase to group B by defrauding group A. That was the story. So there was a technical argument about why there was any connection.

Of course, the problem was that there still needed to be a private right of action. It was clear the justices were chary of private rights of action. My initial draft had proposed an argument that said, essentially, “You don’t need to worry about the potential downsides of private rights of action because here you’ve got a closed class. You’re not worried about everybody in the world who pops up one day and says he didn’t buy. Now I want

trillions of dollars of damages from a company that's worth billions. All the absurd scenarios that you could tell, in which the petitioners brief had, you don't have to worry about it because this offering was done under a consent decree to a limited class. The future can take care of itself."

As I say, the SEC went through the roof. They went through the roof for basically three reasons. They went through the roof because I had removed all of the "We are the SEC, do as we say" language. I had added a textual analysis of the statute in 10b-5, which they didn't like at all because, of course, that kind of analysis detracts from the "We are the SEC and we know best" position. Then I had stuck in this language saying, "You can disagree with Birnbaum and rule for these plaintiffs without opening the floodgates. You can hold onto your hat and see what happens for classes other than things like this consent decree class and others where there was a designated group of targets to whom these shares had been offered with some allegedly fraudulent statement." They didn't like that either, because they thought, "We're going to win this case. We're going to win big."

Over in my office, Commissioner Loomis, David Ferber, and the others basically play the "We are the SEC" line on me. They should have realized that line wasn't apt to be very successful, but the other line was. "Now look, young man, you don't know nothing about securities practice. If we ask around town who the good securities lawyers are, your name isn't on it, and Solicitor General Bork's name isn't on it. We're the good SEC

lawyers. We know who other good SEC lawyers are. And they all think we're the cat's meow."

KD: So is the implication that the SEC was used to steamrolling the solicitor's office?

FE: They certainly seemed to be. Well, it's either that they hadn't needed to in the past because they had found people who were willing to file their kind of briefs, or that they were accustomed to this and it was certainly true. I was five or six months into my tenure in the SG's office. If somebody had asked for a name of people of any import in securities law, I was certainly not on it. So we ultimately reached a compromise, which was reflected in the brief that was filed. It had some of the "We are the SEC" line, and it omitted my effort to show why this would not be a floodgates problem, didn't have very much textual discussion of rule 10b-5 or the statute.

There were many back-and-forth drafts after that. When we had completed this and were about to file it, I said, "Look, I've got a prediction. My prediction is this draft will get you three votes. It will get you Stevens. It will get you Brennan, and it may get you Blackmun, and it will get you no one else." Their response was, "We're sorry, young man. You just don't understand the way the world works." When the case came down, and it was decided six to three against the SEC position with Brennan, Stevens and Blackmun the only dissenters, I think my stock went up. I certainly never had that much problem with the SEC again.

KD: What grounds did you see? Why did you see that the majority was not going to buy that *Blue Chip Stamps*?

FE: Oh, they had already begun. I mean they had decided *Cort against Ash*, the previous year. They had made it clear – not the previous year but about a month or two ago. They had made it clear that private rights of action were much harder to come by, and they were going to be much more textually-focused. Some of the early post-Powell appointment securities cases, the SEC, I think, had won them all. I think *Blue Chip Stamps* was their first loss in quite some number of years. It made it clear that they were much more interested in text. But the main point was that the SEC was assuming that *J. I. Case against Borak* was going to be the model for all securities law for the future. And I thought the justices were making it increasingly clear that *J. I. Case* was an endangered species.

KD: Why? Why do you think they were taking that position?

FE: Because they had had a lot of appointments since *J. I. Case against Borak*, particularly Powell and Rehnquist, who thought that the meaning of federal statutes was to be determined from what the statutes said and not “We are the Supreme Court; we can make up anything we want.”

KD: Right.

FE: And when in court, they got Justice Brennan to sign onto that and say the same thing, you ought to be able to see the handwriting on the wall that *Borak* was dead. Of course, *Borak* is as dead as a doornail except for the fact that it's never been overruled. But one, these days, you can't make a living arguing *J. I. Case against Borak* in the Supreme Court. So that's why. It was Rehnquist and Powell, and of course, Rehnquist ends up writing this case.

I had hoped the SEC would view what happened to them in *Blue Chip Stamps* as a big win because I thought it was. They were never going to win this case. But what the Supreme Court said in the end is that this is a limitation on the private right of action we're willing to imply for private enforcement. That is, they weren't willing to take the *J. I. Case* line that we're just going to continue making up rights of action forever.

Even though I had made it in very brief compass, they bought the argument that the non-sale to this group of people really was in connection with the sale to other people. By buying that argument, they first made it possible for the SEC, in its direct suits, to deal with cases like this. If they hadn't bought that argument, the SEC would have been out of the box for its own suits along this line. That set the stage for other pretty important cases. In particular, it set the stage for *O'Hagan*. When *O'Hagan* comes along and adopts the property rights view of inside trading. We'll have to talk about that because I played a little role in that.

When *O'Hagan* comes along and adopts the property rights view for inside trading law, the first argument that it has to get over is that *Blue Chip Stamps* had knocked out the possibility of suing somebody who just spilled the beans because this lawsuit was against a lawyer who had spilled the beans to other people and had not, himself, bought his old stock. The response was, "No, you misunderstood *Blue Chip Stamps* guys." *Blue Chip* said this was within 10b-5, but we weren't going to imply a private right of action. Well, *O'Hagan* was a criminal prosecution, no need for a private right of action. So by the time of *O'Hagan*, I think they should be jumping in the aisles of the big success in *Blue Chip*, although it did take a while to get there.

KD: Let's go into insider trading a little bit because I understand that you were involved in *Chiarella* in some respect while you were in the Solicitor's office.

FE: Yes, *Chiarella* reached the Supreme Court in my last year in the Solicitor General's office, when I was Deputy Solicitor General. Of course, *Chiarella* was a criminal prosecution, but the SEC was behind the arguments that the US Attorney had made in *Chiarella* to the Second Circuit. The Second Circuit, if I recall correctly, Irving Kaufman wrote the opinion, had said essentially that any trading on the basis of unequal information violates the securities laws. *Chiarella* files a cert petition, and I looked at that, and I said, "What? Huh? How can that possibly be right?" The whole reason why anybody studies securities – and some people studying securities is essential to make the stock market efficient. The whole model of the 1933 and '34 acts is that some people study. There is efficient trading, and most of the rest of us can rely on the price of

securities, which is of course going to form the basis of the fraud-on-the-market doctrine when that comes along.

The courts of appeals had already been doing fraud-on-the-market doctrine. It was the basis of the SEC's differentiation in forms between big companies and small companies. Absolutely essential, I mean if you didn't have a rule that people could trade on different amounts of information, there's no incentive to collect the information. If there's no incentive to collect the information, markets won't be efficient. So I looked at that, and I said, "This can't possibly be right," and handed the papers off to Steve Shapiro who was then an assistant and who was going to succeed me as the economic deputy in a few months. I assume you know of Steve; maybe you even know Steve. He had come from the appellate department of Mayer, Brown, & Platt. He's been head of their appellate department for a long time, in addition to arguing a lot of important securities cases in his role as a private lawyer, in addition to what he did when he was in the SG's office.

I handed this off to Steve Shapiro and said, "Steve, what do you think of this? Can this possibly be right?" No, Steve didn't think it was right either. So we told the SEC we couldn't defend them, at least we couldn't defend the argument that the Second Circuit had adopted. But we were willing to defend the conviction on a different argument, which Steve and I have been thinking about for some time, which was that information about what transactions you were going to engage in, in securities markets is property. Everybody understands that copyrights and patents and other trade secrets and trademarks and so on are species of property.

Well, there's absolutely no reason why a bidder in a case like this couldn't have property rights in information. That's exactly what the bidder had tried to do. The bidder had first negotiated a contract with the printer who was going to print their form 14D, providing for nondisclosure. And of course, the printers, the Vincent Chiarellas of the world, had even agreed that they were bound by this confidentiality. Then the bidder had put all the names in code, so that until the very last moment when they were turned back into normal human names, one wasn't supposed to be able to do it. So this was obviously an assertion of property rights in information.

So Steve and I proposed to the SEC that what we argue is that a misappropriation of property rights. Alternatively, you think of signing a contract, promising to keep X secret, while secretly intending not to honor your contract is a form of fraud. And all you need was fraud in connection with the purchase or sale of securities. There was the necessary connection, see the SEC's victorious part of *Blue Chip Stamps*. This was fraud, and that could be the basis of a conviction.

The SEC may have been, initially, unhappy with that, but they went along with it. And we filed that in the brief in opposition in Chiarella. The SEC was generally more happy first because by the time we had been together for five years they were accepting my judgment a little more about what the justices were likely to do. I think some of the cooler heads at the SEC saw the fact that you can't have an equal information rule and still have informationally efficient markets, right. That what Judge Kaufman had said

was destructive of securities markets. You just couldn't play that game. So they did not withdraw their support from the brief. Of course, it helped that this was a criminal prosecution. Really, all I had to do was persuade the Solicitor General and decide what to do in any criminal prosecution.

So there we were. We took that as the line, and the case was briefed during the period just as I was about to go out the door and hand the case over to Steve. But Steve and I worked on the brief together, and I then vamoosed. I think Steve argued the case himself when the time came. Of course, you know what happened. Some justices thought that this point had not been preserved because it hadn't been made in the court of appeals, but that was true enough.

KD: The misappropriation argument?

FE: Yeah, the misappropriation theory. Nobody was willing to accept this Second Circuit's approach. No, let me take that back; maybe one or two Justices did, but certainly, a majority thought the Second Circuit's approach was loopy. But they never came to a conclusion on it because I can't remember which Justices thought that it had not been preserved. I think Warren Berger wrote an opinion saying that he agreed with it in principle, but didn't think it had been preserved. There were others who didn't think it was preserved. So nothing could happen on that because Steve and I had made it up, no getting around that, sorry.

The next time that problem came before the Supreme Court in the *Wall Street Journal* case; I think Steve may still have been there. I was certainly long gone. The government took the same position again. And that time the justices split four to four on it. And then it finally comes back in *O'Hagan*, cleanly, and gets adopted.

KD: But at this point, misappropriation is being used; it's not coming at the back end of the process.

FE: Right, by that point, the misappropriation theory was being widely used in the courts of appeals and the district courts and was being talked about in the academic press. So it was well preserved for the Supreme Court to decide. In *O'Hagan*, it carries the day.

KD: There's a lot of time in between *Chiarella* and *O'Hagan*?

FE: Yes.

KD: Were you seeing this when you were here in the Seventh Circuit? Were you seeing cases that were developing with that argument?

FE: No, we had very few takeover cases in the Seventh Circuit, and that's where it mainly became important, as it had been in *Chiarella* itself. There were a couple of cases that I sat on where I thought –

KD: Insider trading cases or takeover cases?

FE: Well, *Chiarella* was a takeover case. It was mis-argued as an inside trading case. That was one of the points that's made in *O'Hagan*. *Chiarella* was not an insider in anything like the standard way, for the reason that the Supreme Court was to say in *Dirks against SEC*. That is he was not an officer or agent of the target. He didn't have any fiduciary duty to the target. The Supreme Court said, in *Dirks*, that you can't use an inside trading theory unless this person is violating a fiduciary duty of some kind. So *Dirks* didn't have a fiduciary duty to National Student Marketing, and *Chiarella* didn't have a fiduciary duty to the target. Mr. O'Hagan didn't have a fiduciary duty to the target. These were outsider trading cases. These were certainly cases of trading on unequal information, and a lot of times that gets converted by shorthand into inside trading, but I'm resisting that because, well, they weren't insiders.

But what was true about Vincent Chiarella, was true about O'Hagan, and they are both takeover cases, is that they were trading based on information that belonged to somebody else, and which they had promised by contract not to use themselves. It was just a fill-up that Mr. O'Hagan was trading on; I think it was, Grand Met was the bidder. O'Hagan was trading on Grand Met's information to cover his embezzlement from client trust funds for other clients. Oh my God. When I was teaching securities law, I did suggest to my students that first, it's probably not a good idea to embezzle from client trust funds, but if you do, it's certainly not a good idea to commit some other crime to try to cover up your embezzlement. Things can get worse, you know.

KD: When you're talking about working with the SEC and the Solicitor General's office, a lot of what you're characterizing is sort of personal relationships and certainly a sense of conservatism or just doing it the way it had always been done on the SEC's part. Were there any natural divides between the way Justice and the SEC was looking at things that were an outgrowth of their position in the government?

FE: Well, they were both personal divides and divides based on position. When you think about the personal divide, David Ferber is a wonderful lawyer, but he had been there so long by the time I arrived, and he had such an institutional memory; I think even longer than Phil Loomis' that the way things had been done in the past had been very satisfactory to the commission. They had been extremely successful in the Supreme Court and the courts of appeal. You can imagine somebody like Dave Ferber just "Here's our formula for success, let's keep it that way."

The turnover in the Justice Department was much more rapid. They were dealing with me. I'd been there for five months at the time *Blue Chip Stamps* arrives. By the time I left, I had been there a total of five years, and I was an old hand. The very oldest hand in the Solicitor General's office, Larry Wallace – well, Dan Friedman was the very oldest hand, but Dan didn't work on securities cases. He worked on antitrust and a bunch of others, was appointed Chief Judge of the Court of Appeals in '79, and he was gone before I left. He was appointed in '78. Larry Wallace was the next oldest hand. He had come in the sixties, but he had nothing to do with any economic cases. The people who

did have things to do with economic cases, people like Keith Jones and me and Steve Shapiro, Ken Geller after Steve, were people who turned-over much more often.

So the SEC had this memory of the way things had been done, which the people in Justice didn't have. There was also an institutional difference between Justice and the SEC. The SEC has worried a lot about securities doctrine. Most of the Justice Department is not worried in the slightest about securities doctrine. People in the SG's office are often worried about doctrine, about long-term, what is this going to do for the future of this agency or the future of this. But many of these cases, and of course *Chiarella* was one of them, are criminal prosecutions. Well, I'll come later to *Naftalin*, which is another criminal prosecution that I worked on. Mostly these cases are launched by assistant US attorneys who are sure that the defendant is a really bad guy. Their goal is to make sure bad guys go to jail and good guys stay out and much less concerned about securities doctrine.

So in *Chiarella*, which was a criminal prosecution and, therefore, within the control of the criminal division until it gets to the SG's office, people in the criminal division are perfectly happy to take any old argument that will support the conviction without particular concern for what that does for long-term securities law, whether that's going to jeopardize the efficiency of markets in the long term. They have no interest in that.

My bet is that there are a lot of people who had been in the SG's office before or after me who share the criminal division's or the civil division's perspective more than the SEC's

perspective. I was really interested in the development of securities law and, therefore, more concerned about doctrine. The SG's office is, as a rule, is more concerned about doctrine than the divisions are, but the SEC even more so concerned about long-term securities doctrine.

KD: Are there any other highlights from the Solicitor General's years?

FE: By the way, just to add that observation about the effect of different personalities, I was there with three different general counsels. I was there with Ralph Ferrara and Harvey Pitt, and Larry Nerheim, the general counsel at the time of *Blue Chip Stamps*. So I got to know all three of those general counsels. Since they tended to be much shorter-term people than Dave Ferber; Ralph Ferrara was shorter-term than Dave Ferber, I tended to get along with them a lot better. I think they, themselves, often had the reaction that this long-term institutional of bureaucracy wanted the new general counsel and wanted the new commissioners and so on to conform to some old model. And the general counsel, who had at least the virtue of being a higher-level of appointment, tended to think that really maybe they were in charge.

KD: And perhaps a broader viewpoint too?

FE: Yes.

KD: Anything else we should touch on from your time in the SG's office because I really want to spend some time on working as a judge in the appeals court?

FE: Well, I want to mention one more case from my time in the SG's office, a case that essentially nobody pays any attention to any more, but which I thought was, in many ways, the most important case I worked on in the SG's office and the (indiscernible 39:41) securities case I worked on. It was the *United States against Naftalin*. Ever heard of it?

KD: Never.

FE: Ah, well there's my point. What had happened in *Naftalin* was that Naftalin had made a naked short trade. Naftalin contracts with his broker to sell some shares short, and as part of this, he represents to his broker that he owns the shares, but in fact, he didn't. He was making a naked short. And when the time comes for him to hand over his shares, he says, "Well, I'm sorry. I don't have these shares, and I'm broke, and I can't cover." So the broker, who had guaranteed the trade, covers for him, and is really upset. A criminal prosecution ensues under Section 17 of the Securities Act from 1933, if I recall correctly. The Eighth Circuit reversed the conviction, and it said, "No, you can't prosecute Naftalin because the only person who was injured here was the broker."

The customer, the person who bought the shares short from Naftalin wasn't injured because the broker had guaranteed the transaction, and so the broker had to cover it when

Naftalin didn't. And we all know the securities laws are designed for the benefit of investors, and now here cite fifty Supreme Court cases saying that securities laws are designed for the benefit of investors and, therefore, conviction reversed.

I took that case to the Supreme Court. I think it was against the recommendation of the criminal division. I took that case to the Supreme Court and said roughly, "Yeah, well we all know that the securities laws are for the benefit of investors, but actually, they're criminal statutes. They've got language in them. The question is what is the language of this criminal statute say? Does it say securities fraud only when an investor is injured, or does it say fraud in connection with a securities transaction?" There is no doubt Naftalin committed fraud. He lied to his broker about whether he had the shares. There's no doubt that this was a securities transaction. There's no doubt that he had scienter; that is, he knew he didn't have the shares. There's no other element in this statute, and we think you guys ought to be enforcing the statutes as written. They reversed nine to nothing, very short opinion in *Naftalin* saying, "Let's get past all this hot air about purposes and goals and so on. Let's actually enforce the statutes as they are written, even if this is against our druthers."

By the way, the SEC was just delighted with this, just delighted. I pulled the brief in *Naftalin*. I can't remember who the general counsel was at the time. Actually, there was no general counsel on it. It may have been between general counsels, but David Ferber's name on it. He was really happy with this. It's been an enormous boon to the SEC to be able to get away from some of the past because these laws are extraordinarily, broadly

written. And if you put to one side all of the difficulties of private rights of action or aiding and abetting claims in private actions, where it's the SEC is the plaintiff, where the US is the plaintiff, there is plenty of expressed statutory authority to insist that these markets be operated without fraud, and to get a holding like *Naftalin*, which they can cite and have been citing ever since, for the proposition, "Don't let your jargon distract you from what's actually in the statute." That was, I think, the best thing that happened to the SEC in quite some time.

KD: Was this just an assumption that grew out of the old widows and orphans thing from the 1930s? That's what they had been focused on.

FE: That's what the Eighth Circuit pretty much said in *Naftalin*, and we got the Supreme Court to disapprove that.

KD: Well, how did all of this start to look once you got on the Seventh Circuit, and you're on the other side now? Looking at this as a historian, I want to get a sense of change and how the Supreme Court's and the lower court's views of securities laws and case law is changing over time. Can you give me a sense of that?

FE: I don't think there's been very much change. What has been happening, in the years I've been a judge and for that matter in the six years in between when I was a full-time teacher and scholar of corporate securities and antitrust law, has been roughly more and more *Naftalin*. That is, the justices, at the urging of Lewis Powell and even more at the urging

of people like Antonin Scalia and Clarence Thomas and Ruth Ginsburg, I'm happy to say, have been insisting that instead of having your preconceived notions about what statutes are for or how they operate or what would make for a good world or anything like that, have been looking at the language of the statute. Looking at the language of the statute has a bunch of great virtues. It has the virtue of legitimacy. Congress enacts these things, and they're actually supposed to be enforced as laws without judges making up something instead and the virtue of predictability so you can see what's going on. This has cut both ways.

A case like *Dabit*, which I was involved in remotely is a great example. Congress passes Securities Litigation Uniform Standards Act, and the Securities Litigation Uniform Standards Act says you can remove from state court to federal court any class action that is within the scope of the securities laws, any case within the scope of the securities law. It then becomes a case under federal law, and you have to show that you win under federal law to get any remedy. It prevents state courts from engaging in hometown jurisprudence.

This has always been a risk in securities law. Since the hometown investors bring the suit in state court, most of the people who are going to have to pay the judgment are from out-of-state. You will always get an incentive to do something for your local constituents who are electing you to the bench, not a good thing. Having these cases adjudicated by the federal courts is helpful because federal judiciary is really federal, and the investors

and the payors and the plaintiffs and the defendants are all part of the jurisdiction, so they get equal consideration.

In *Dabit*, which involved timing of trades in mutual funds to try to take advantage of price movements overseas where you could get a transaction done after the closing time in New York and get a few mils on each trade, but with lots of trades, a few mils adds up. And you're really subtracting from long-term investors in the fund. All right, so these suits were suits by the long-term investors against the mutual funds, and *Dabit* was removed from state court. The Second Circuit said, in *Dabit*, that this case had to go back to state court because after it was removed from state court, there couldn't be any federal remedy. See *Blue Chip Stamps* because the people who were suing the long-term investors in the fund were not the purchasers and sellers.

I had, meanwhile, written an opinion on the Second Circuit for the Seventh Circuit. That is, these lawsuits were filed in three circuits. They were filed in the Second, the Seventh, and the Ninth. That's pretty common for securities cases. Interesting securities problems get to be filed in the big commercial centers, which means they're being filed in New York; they're being filed in Chicago; they're being filed in Los Angeles.

I had written an opinion called *Kircher against Putnam Funds* which had disagreed with the Second Circuit's opinion in *Dabit*. My opinion had said, "Look, there's nothing in the federal statute which says you have to have a remedy. It only says that this has to be within the scope of the federal securities laws. We know from *Blue Chip Stamps* and

O'Hagan that it is within the scope of the securities laws because this was a fraud. At least, it's alleged to be a fraud in connection with the purchase or sale of these mutual fund shares. The fact that you, particular plaintiffs, don't get a remedy because of *Blue Chip Stamps* doesn't mean it's outside the scope of the securities laws. It just means that you're not the right person. This suit should be filed by the SEC."

The Supreme Court comes along in *Dabit*, in another unanimous opinion, reverses the Second Circuit, approves the Seventh Circuit approach, and again, it's a *Naftalin* exercise because we've read the statute. The statute says in connection with the purchase or sale. We can show you this is in connection with the purchase or sale. We're less interested in these over-rides about private rights of action. We just want to get the statute right, and getting the statute right will actually allow the agency to bring the right suits, and the SEC then brought some of its own. There's been substantial change in the turnover practices of these funds.

KD: There is the appearance of change here, though, because when *Dabit* comes out there is much wailing and gnashing of teeth and the narrowing of class action and all that stuff.

FE: But it's completely wrong. The reason why *Dabit* was unanimous is the same reason why *Naftalin* was unanimous. The justices have stopped caring about who wins and have started caring about what does the law actually provide? By caring about what the law actually provides, it means that when the SEC gets Congress to write a broad statute, it's going to get broadly enforced. And when the defense gets Congress to write a narrow

statute, it's going to be narrowly enforced. The message that should have been taken away from *Dabit* was not "Gee, these plaintiff class actions are being dismissed." It is "The Supreme Court confirms the SEC's authority to fix this problem."

As the Second Circuit had handled *Dabit*, although there was going to be litigation in state court, the SEC had no authority to fix the problem. Now, who do you want regulating mutual funds, a bunch of state judges who don't know securities from, well goodness only knows what, or the SEC? You want the SEC fixing the problem with the mutual funds. That's what *Dabit* did. *Dabit* gave the solution to the person who actually might have known what they were doing.

KD: Great. Another one, there has also been the shift with the aiders and abettors. Most recently, *Stoneridge*, and again, here we've got this impression of this great narrowing of something that had been going in the other direction before.

FE: Yes. I was actually particularly happy when the Supreme Court got rid of private aiding and abetting litigation, again, on *Naftalin* grounds. I had had a couple of those cases as an appellate judge before the Supreme Court handed down the *Denver Bank* case.

KD: What were your cases? Do you remember?

FE: I can't remember what they were, but we had done our best to narrow it by saying "Even though this circuit had adopted aiding and abetting liability, we weren't going to allow

liability unless, at a minimum, you had made yourself one of the contested statements.” Just having provided information to a person who made a fraudulent statement didn’t seem, to us, enough. When they took *Denver Bank*, I was delighted because my frequent co-author and co-conspirator, Daniel Fischel, was the reason why they granted that case. The courts of appeals, the regional circuits, were unanimous that aiding and abetting liability was proper. Dan Fischel had written an article which questioned that consensus. Dan had said, “I’ve looked in the statute. I can’t find any aiding and abetting liability. I can find provisions in the statute dealing with secondary liability.” It’s the control person liability statute. If you are in control of or controlled by somebody who violates the securities laws, then you’re liable, too. But if you’re not in control of or controlled by that person, then you’re not liable, with one possible exception.

The US attorneys can enforce criminal violations of the securities law, and there is an aiding and abetting provision in the criminal, in Title 18, the criminal statute. Aiders and abettors are treated as principals. So the upshot of that, Dan says, is there’s aiding and abetting liability in private securities litigation, only to the extent that you meet the control person definition in Section 20. But there is general aiding and abetting liability in criminal and SEC cases because that’s the consequence of 18-USC Sec 2. Again, there’s the distinction between private liability and liability with public presenter. That, of course, is the argument that the Supreme Court agrees with in *Denver Bank*, and it’s been very resistant to changing since. But I thought it was wonderful.

There was a conflict between all of the circuits and Professor Fischel. The Supreme Court grants certiorari to resolve the conflict between Dan Fischel and every appellate court in American, and it rules in favor of Dan Fischel. Well, what a great thing to do, but it did it on the ground that here's the text of the statute, and we're not going to make it up. It disappointed me that there were four dissents in that case. The dissenters seemed to be very much glued into history. Here's the majority view in the court of appeals. Why should you abandon it? Congress implicitly endorsed it when it didn't change it, and we're really confident that Congress will authorize this explicitly now that you've thrown down the gauntlet.

I think those lines of argument by judges are very bad, and I try to avoid them myself. I try to avoid the first half of this, which is "Congress implicitly endorsed the judicial view by not getting rid of it," because that's not what the Constitution says. Congress acts by enacting things. It doesn't act by not doing anything. So this text is enacted in '33 and '34. Congress doesn't change it after that. It had whatever meaning it had in '33 and '34. I had always thought that was the lesson of the one-house veto cases, which said that if one house disagrees with something, the agency has to stop. Well no, that's not true. Congress creates or changes law by passing laws and getting the president to sign them or overriding a veto.

So this whole line that the judges said X, Congress didn't legislate against that, therefore, X must be the law, inverts the process. What judges say can't possibly change the law. Well, I was happy to see that rejected, but that's an old heresy that is still with us. You

still see that kind of thing in judicial opinion, and it still distresses me, and every once in a while I write an opinion explaining why it's nonsense. But as I said, you still see the heresy. Now I've forgotten what the other problem I had with that was.

Oh yes, the prediction, dissenting opinions and we certainly saw this in *Denver Bank*. We've seen it in others. Dissenting opinions are fond of saying, "And we know what it is Congress wants and I'm sure Congress will overrule this opinion; therefore, this opinion is not correct." That's wrong both on grounds of theory. The meaning of the Securities Act of 1933 depends on what was enacted in 1933. It doesn't depend on what I think people will enact in 2011. But it turns out, if you look at the history of this in Supreme Court opinions, almost every time a dissenter says, "I'm confident that Congress will overturn today's decision," the dissenter is proved to be wrong. The history of *Denver Bank* is certainly along those lines. The dissenters are confident that Congress will allow private aiding and abetting suits.

It turns out when they get back to this issue in Sarbanes-Oxley, what do they do? They beef up the SEC's ability to file aiding and abetting suits, an ability the SEC had had all along under Fischel's approach, but which gets beefed up. And the claim for private aiding and abetting suits is, well, it doesn't show up, and it's still not there. What we've seen ever since is efforts to get around it by claiming that if one or another kind of behavior by aiders and abettors is really direct liability. So they rejected one of those theories in *Stoneridge* last year. They've got another one on the docket this year, in an

effort by the Ninth Circuit to get around *Denver Bank*. I won't try to predict what the outcome will be this year, but we know what happened in *Stoneridge*.

KD: Well, that gets to some general things I want to –

FE: And I see things like this all the time in my capacity as a circuit judge, and as you might expect from what I've already said, I'm not very sympathetic to all of that, to try to get around Supreme Court decisions.

KD: Right, as a circuit judge and working with your colleagues, how much do you anticipate what you think the Supreme Court is going to do or how you think it's going to come down on securities cases?

FE: I don't try to anticipate what they're going to do. At least, I don't anticipate that as an element of decision. I generally assume that broad jurisprudential currents stay what they are. We have been, ever since the seventies, in a period of textualism. I don't want to say ever since Lewis Powell was appointed, but the appointment of Powell and Rehnquist did a lot in that direction. The appointment of Scalia and Thomas and Alito and Roberts has furthered that. We've been in an era where the meaning of a statute depends on what the statute says rather than on what other people do. So I take account of that general jurisprudential position. If the Supreme Court were tomorrow to say "We're tired of the approach of *Naftalin* and *Dabit*; we're going to go back to *J. I. Case against Borak*," I would try to do that.

But by and large, in these cases, securities cases aren't statutory cases. The main thing I'm trying to figure out is, "What does this statute mean? If the Supreme Court in some cases told me what that statute means, then gee, that's what that statute means. If the Supreme Court hasn't, then I have my sense of what its general approach is that it's the textual approach. I will do my best to figure out what that statute means, not trying to guess what they will think the statute means. I'll try to figure out what I think the statute means, as best I can.

KD: You're talking about some fairly arcane subjects, and not every judge is going to have the kind of expertise that you've developed over the years. In the Seventh Circuit and elsewhere, are there specializations? When you're working with other judges, would you tend to cede things to them that they're very good at, and would you take securities cases?

FE: Oh, sure. There is no specialization. There's no securities court. Our judges are assigned to appeals randomly. So I'm no more likely to be on a securities case than any other judge is. But if I'm on a securities case, these days, of course, as chief judge I'm always the presiding judge. I'm very likely to assign it to myself because that's an area of interest to me. Other judges have their own areas of interest, and I'm likely to assign cases to them. Of course, first I have to be in the majority to assign it to me. And this has been my practice, not only my practice, but my sense of the practice of the court ever since I got here.

When I arrived in 1985, the other judges knew that my academic specializations had been corporations, securities, and antitrust, and if there was an antitrust case that the panel was hearing, they were very likely to assign it to me. If there was a case that they were much more knowledgeable about than I, they were likely to assign it to themselves. So we get some benefit of the division of labor that way. We also get the benefit of the division of labor by discussing things among ourselves.

Maybe fifteen years ago, we had a securities case that was assigned to a panel that had nobody on it who knew securities law from Adam. And the judge who was assigned the opinion wrote me a long memo inquiring, and we sat down and talked about it at length. I gave him my views about how this case should be resolved. He was persuaded; the panel was persuaded. They handled the case that way. They thought it was perfectly sensible, and it got reversed five to four, extremely annoying.

KD: I can't leave you without talking a little bit about law and economics, generally. I think you've made the case yourself that antitrust was a natural place for the law and economics movement to have a great deal of influence. Can you say the same thing about securities law?

FE: Yes and no. The way the antitrust statutes are written, they're fundamentally an invitation for the judiciary to make up a common law for restraining trade. That actually is what Circuit Judge Taft said in the first and, I think, still the most important antitrust case, the

Addyston Pipe case that Judge Taft wrote when he was a judge of the Sixth Circuit.

That's not true about securities law. As I've been saying for the last hour, I think securities law is a set of very complex statutes plus a delegation to the SEC. Judges serve best by carrying out complex statutes the way they're written and respecting the delegation to the agency precisely because most judges aren't experts in securities law or anything else.

I do think it helps; an economic background helps, because a lot of these transactions require economic understanding. You have to know why people are doing what they're doing. When I said, in describing *Naftalin*, that this was a naked short, you knew exactly what I was talking about. If I walked up to most of my colleagues and said there was a naked short in *Naftalin*, they would go, "What? Why is somebody walking around without his shorts?"

KD: Yes sounds prurient.

FE: Yes, it sounds prurient. It helps to know what's being done. But in that sense, I don't think it helps more in securities than it does, say, in tax. We get a lot of complex corporate tax transactions where we need to figure out what the tax is on a reverse triangular merger. It helps to know what a reverse triangular merger is before you can figure out the tax on it, but it doesn't mean that because I know a lot about corporate law, I would have my distinct view of corporate taxation because again, that's handled by a

very complex statute and a delegation to the Treasury to fill in the gaps. So it helps a lot to know, but it helps in a very different way from the way in which it helps in antitrust.

KD: So I guess it's fair to say then, perhaps, we haven't seen as great a change in securities law as we've seen in antitrust law over the last generation or so?

FE: Oh, we've seen a very great change in both, although I'd put it over the last two generations. Again, it begins in the seventies.

KD: Okay.

FE: The change we saw in antitrust law in the seventies was that the justices had to change their conception of what competition is. Instead of asking ex post the transaction, did the transaction reduce the number of competitors, the justices began to ask ex ante the transaction was there competition for the contract. So if you get a sole source contract for selling tires to Ford, the question was not did that foreclose business once the contract had been signed. Well, of course it did, but was there competition before Ford bought the tires or the spark plugs or something like that? And the justices' view of that has been, now for thirty-five years, very much in agreement with the view of Chicago School and antitrust because they had changed their conception of what competition is.

The change in securities law has been from a "Gee, let's do what we think the public interest requires conception," the kind that's in *Case against Borak*, to "Let's do what the

statute says.” Of course, that’s broadly congruent with the changes in much else of the rest of the Supreme Court’s docket. I think there’s been a big change in both, and I think it’s been very much for the better, in both securities law and antitrust law.

KD: Anything else we should talk about?

FE: Oh, I think that covers a lot.

KD: That’s a good place to stop. Thank you so much.

FE: Okay, good.

[End of Interview]