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# THE SCIENTER REQUIREMENT IN ACTIONS UNDER RULE 10b-5†

DAVID G. EPSTEIN\*

More than twenty years have now elapsed since a private right of action under rule 10b-5<sup>1</sup> was first recognized judicially. In the interim, rule 10b-5 has become "the most prolific source of litigation since Henry Ford invented the flivver."<sup>2</sup> And, the Rule is assuming even greater importance. Private actions under 10b-5 in excess of seventy-seven million dollars have been instituted against Texas Gulf Sulphur and its officers and directors.<sup>3</sup> The Securities and Exchange Commission proposals to implement the Wheat Report will result in an increased emphasis on 10b-5.<sup>4</sup> Notwithstanding the importance of rule 10b-5 and the numerous reported decisions<sup>5</sup> and legal writings devoted to it and its nuances,

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† The awkwardness of entitling a study of a specific element of a cause of action under a rule promulgated pursuant to a section of one of several federal securities laws brings to mind the remark of Lord Devlin:

Composing a title for an address is sometimes just as difficult as composing the address itself. I wish that a legal composer was given the same freedom on this point as a musical composer. He can write what he likes and can call it a Sonata in F minor, or a Suite for Strings and Timpani—or, if he considers himself very famous, just Devlin in G.

P. DEVLIN, *SAMPLES OF LAWMAKING* 104 (1962).

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<sup>1</sup> 17 C.F.R. § 240.10b-5 (1969). Rule 10b-5 was promulgated by the Securities and Exchange Commission under the enabling authority of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1964). The rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

<sup>2</sup> Bangs, *Rule 10b-5 and the South Dakota Lawyer*, 14 S.D.L. REV. 56, 79 (1969).

<sup>3</sup> See Knauss, *Disclosure Requirements—Changing Concepts of Liability*, 24 BUS. LAWYER 43, 53 (1968).

<sup>4</sup> SEC, PROPOSALS TO IMPLEMENT THE WHEAT REPORT (CCH Special Rep. No. 272, 1969).

<sup>5</sup> Decisions involving rule 10b-5 are mainly on the pleadings. As Professor

serious questions remain largely unanswered, particularly with regard to the elements of a private action under the Rule.<sup>6</sup> This article will treat one such question: the role of scienter in a private action under rule 10b-5 for misrepresentations in the sale of securities.

### I. THE MEANING OF SCIENTER

It is first necessary to ascribe some meaning to the term "scienter" as used herein. There is a substantial amount of Lewis G. Carroll's Humpty-Dumpty in all of us.<sup>7</sup> Everyone—especially appellate court judges and contributors to legal periodicals—has the tendency to define terms arbitrarily. As a result, numerous definitions have been given the term "scienter" as used in connection with fraud. As Professor Loss has observed:

[Scienter] . . . has been variously defined to mean everything from knowing falsity with an implication of *mens rea*, through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault. . . .<sup>8</sup>

In an effort to avoid succumbing to the Humpty-Dumpty syndrome, scienter shall here be defined by illustration rather than in the abstract.

Dean Keeton has isolated the several possible states of mind of a party making a misstatement into five more or less separate classes: a person makes a misrepresentation (1) justifiably convinced of the truth of the statement, or (2) believing in the truth of the statement but knowing that he has insufficient knowledge on which to base such a belief, or (3) having no genuine belief whatsoever in either the truth or the falsity of the statement, or (4) realizing that the statement was probably false, or (5) convinced of the falsity of the statement.<sup>9</sup> For

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Bromberg has stated: "[T]he typical 10b-5 'victory' is only a holding that a cause of action has been stated, good enough to withstand a motion to dismiss." A. BROMBERG, *SECURITIES LAW: FRAUD* §1.3(2) (1967) [hereinafter cited as BROMBERG].

<sup>6</sup> Professor Hamilton is much more emphatic on this point: "The case law arising under Rule 10b-5 is in a chaotic mess." Hamilton, Book Review, 46 *TEXAS L. REV.* 815 (1968).

<sup>7</sup> "When I use a word," Humpty Dumpty said, in rather a scornful tone, "it means just what I choose it to mean—neither more nor less." L. CARROLL, *ALICE'S ADVENTURES IN WONDERLAND AND THROUGH THE LOOKING GLASS* 186 (1916).

<sup>8</sup> 3 L. LOSS, *SECURITIES REGULATION* 1432 (2d ed. 1961) [hereinafter cited as Loss].

<sup>9</sup> Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 *U.C.L.A.L. REV.* 583, 589 (1958).

purposes of this paper "intentional" describes Class Five; the term "scienter" encompasses Classes Three, Four, and Five. Class Two is "negligence," and Class One is "innocent."

## II. CASES CONSIDERING SCIENTER IN 10b-5 ACTIONS

Since the courts "created" the private action under rule 10b-5<sup>10</sup> and extended this remedy to buyers as well as sellers,<sup>11</sup> it seems only proper to look first to judicial interpretation in deciding the role of scienter in a private action under the Rule. The necessity of proof of scienter in a private action under rule 10b-5 was first discussed in *Fischman v. Ratheon Manufacturing Co.*<sup>12</sup> There the common stockholder-plaintiffs alleged that they were induced to purchase stock in the defendant corporation by misstatements and omissions in a prospectus that covered only preferred stock. Relief was sought under section 10(b) and rule 10b-5. The trial court dismissed, holding that since the buyers' action was based on allegedly false statements in a prospectus, section 11 of the Securities Act of 1933 constituted their exclusive remedy. Since relief under section 11 is limited to those purchasing the stock issue covered by the prospectus, it was held that the plaintiffs had failed to state a cause of action.<sup>13</sup> The Second Circuit reversed, stating: "[W]hen, to conduct actionable under § 11 of the 1933 Act, there is added the *ingredient of fraud*, then the conduct becomes actionable under § 10b of the 1934 Act and the Rule . . . ."<sup>14</sup> The remainder of the opinion affords no guidance as to the meaning of the phrase "ingredient of fraud."

In *Weber v. C.M.P. Corp.*,<sup>15</sup> a district court defined this phrase as meaning "knowledge of the falsity of the alleged untrue statements."<sup>16</sup> The definition is consistent with the interpretation attributed to *Fischman* by most courts and legal writers and with the present day concept of

<sup>10</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). See generally Dykstra, *Civil Liability Under Rule 10b-5*, 1967 UTAH L. REV. 207, 209-11.

<sup>11</sup> See *Fischman v. Ratheon Mfg. Co.*, 188 F.2d 783, 786-88 (2d Cir. 1951); BROMBERG § 2.4(2); 3 LOSS 7778-91.

<sup>12</sup> 188 F.2d 783 (2d Cir. 1951).

<sup>13</sup> *Fischman v. Ratheon Mfg. Co.*, 9 F.R.D. 707 (S.D.N.Y. 1949). The court made mention of section 12(2) of the 1933 Act but seems to have ignored its availability.

<sup>14</sup> 188 F.2d at 787 (emphasis added).

<sup>15</sup> 242 F. Supp. 321 (S.D.N.Y. 1965). The court went on to question, but nonetheless to follow, the *Fischman* formulation.

<sup>16</sup> *Id.* at 323.

the term "fraud."<sup>17</sup> Although cases allowing recovery for negligent misrepresentation are sometimes referred to as "fraud" cases,<sup>18</sup> the prevailing view is that they are grounded in a theory of recovery separate and distinct from fraud.<sup>19</sup>

*Fischman* has received little judicial acceptance. While several New York district court decisions have followed it,<sup>20</sup> only one court outside the Second Circuit, the district court of Colorado, can be said to have taken a similar position. In *Trussell v. United Underwriters, Ltd.*,<sup>21</sup> the plaintiffs were stock purchasers seeking damages from the defendant seller-issuer. The complaint contained five counts, three of which charged misrepresentations and omissions in violation of rule 10b-5. Of these three, the first merely itemized the misstatements; the second incorporated the first and added the allegation that the defendants had full knowledge of the falsity of the representations and of the fact that plaintiffs would rely upon them; and the third<sup>22</sup> charged that the statements constituted negligent performance by the defendants of their duty to disclose full, complete, and accurate information. The first and third counts were dismissed by the district court as insufficient in that they contained no allegation that the misstatements were made knowingly or intentionally.<sup>23</sup> In dictum, the court explained its concept of knowingly or intentionally as including a representation made with reckless disregard of the truth or falsity.<sup>24</sup>

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<sup>17</sup> See, e.g., R. JENNINGS & H. MARSH, *SECURITIES REGULATION CASES AND MATERIALS* 866-67 (2d ed. 1968); Comment, *Securities Regulation—Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems*, 46 N.C.L. REV. 599, 623-25 (1968). But see E. GADSBY, *FEDERAL SECURITIES ACT OF 1934* § 5.03[1][d] (1967).

<sup>18</sup> E.g., *Bobby Jones Garden Apts., Inc. v. Suleski*, 391 F.2d 172, 177 (5th Cir. 1968), quoting from *Kutner v. Kalish*, 173 So. 2d 763 (Fla. Dist. Ct. App. 1965).

<sup>19</sup> See W. PROSSER, *LAW OF TORTS* § 102, at 720 (3d ed. 1964).

<sup>20</sup> See *Globus v. Law Research Serv. Inc.*, 287 F. Supp. 188, 197-98 (S.D.N.Y. 1968) (something more than a negligent misstatement); *Gould v. Tricon, Inc.*, 272 F. Supp. 385, 393 (S.D.N.Y. 1967) (proof of fraudulent conduct essential); *Richland v. Crandall*, 262 F. Supp. 538, 553 n.12 (S.D.N.Y. 1967) (intent to defraud or guilty knowledge) (dictum); *Webber v. C.M.P. Corp.*, 242 F. Supp. 321, 325 (S.D.N.Y. 1965) (deception in the sense of cheating).

<sup>21</sup> 228 F. Supp. 757 (D. Colo. 1964).

<sup>22</sup> This was actually the plaintiffs' fourth claim; their third claim alleged violation of the state blue sky law. For a discussion of the problem of pendent jurisdiction posed by this claim, see 40 WASH. L. REV. 352 (1965).

<sup>23</sup> 228 F. Supp. at 773-74.

<sup>24</sup> *Id.* at 772. Accordingly, it would seem that in Colorado, as well as in states within the Second Circuit, only misrepresentations made with a state of mind coming within Classes Three, Four, or Five of Dean Keeton's classification of misstatements would give rise to private actions under rule 10b-5.

The precedential value of *Trussell* today is somewhat questionable. In *Stevens v. Vowell*,<sup>25</sup> the Court of Appeals for the Tenth Circuit, which includes Colorado, stated:

It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact.<sup>26</sup>

Then in *Parker v. Baltimore Paint & Chemical Corp.*,<sup>27</sup> the Colorado district court found the above language to be dictum and reaffirmed the requirement for scienter imposed by *Trussell*.<sup>28</sup> The facts of *Stevens* give support to this finding. There the defendants had represented that the entire amount of the investment would be used for the construction of Arro-Triever archery lanes in Utah; the defendants in fact had no connection with the actual owner of Arro-Triever and no such lanes were ever built. These facts permit at least in inference of fraud, and the plaintiff's complaint so alleged.

There is also a line of cases supporting the position that scienter is not required by rule 10b-5; the leading one is *Ellis v. Carter*.<sup>29</sup> In it, as in *Fischman*, a buyer sought to recover for allegedly *fraudulent* misrepresentations under rule 10b-5. As in *Fischman*, the defendants contended that rule 10b-5 affords no right of recovery to defrauded buyers, and the contention was rejected by the court.<sup>30</sup> But unlike the Second Circuit, the court in *Ellis*, in rejecting this contention, stated that a showing of common law fraud is not essential to the establishment of a cause of action under 10b-5.<sup>31</sup> There is language in the opinion indicating that even innocent misrepresentations may be a basis for recovery under the Rule,<sup>32</sup> and *Ellis* has been read in such a manner by several legal writers.<sup>33</sup> No court has actually held that liability will attach for a misrepresentation that is neither negligent nor intentional although there is language in several cases other than *Ellis* that would seem to support such a holding.<sup>34</sup>

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<sup>25</sup> 343 F.2d 374 (10th Cir. 1965).

<sup>26</sup> *Id.* at 379.

<sup>27</sup> 244 F. Supp. 267 (D. Colo. 1965).

<sup>28</sup> *Id.* at 270.

<sup>29</sup> 291 F.2d 270 (9th Cir. 1961).

<sup>30</sup> *Id.* at 273-74.

<sup>31</sup> *Id.* at 275 n.5.

<sup>32</sup> *Id.* at 274.

<sup>33</sup> See BROMBERG § 8.9 n.102; R. JENNINGS & H. MARSH, *supra* note 17, at 866-67.

<sup>34</sup> *E.g.*, *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962);

*Ellis* has received as little judicial recognition as *Fischman*. While several courts have indicated by means of dictum their approval of the position on scienter taken in *Ellis*,<sup>35</sup> only one district court can be said to have based a decision on that case. In *Hendricks v. Flato Realty Investments*,<sup>36</sup> a federal district court relied on *Ellis* to reject a motion to dismiss an action for alleged misrepresentations in the sale of securities based on rule 10b-5 even though the complaint failed to allege scienter. The decision contains no discussion of the reasons for following *Ellis*; the court simply stated: "This court feels that the logical approach of *Ellis* has much to be recommended in a situation of this nature and I am persuaded to follow it."<sup>37</sup>

In *Drake v. Thor Power Tool Co.*,<sup>38</sup> an Illinois district court took still a third position. Plaintiff Drake alleged that he had purchased stock in reliance on false figures in Thor's financial statements and that defendant accounting firm had failed to exercise proper and appropriate auditing procedures in examining the financial statements and in rendering its opinion that the statements fairly represented the financial position of Thor. No charge having been made that it knew of the alleged misrepresentations in the financial statements, defendant accounting firm, contending *inter alia* that knowledge is a necessary element of a claim under rule 10b-5,<sup>39</sup> moved to dismiss. The court rejected both the rationale of *Ellis*<sup>40</sup> and the defendant's contention and construed the allegation of improper auditing procedures as an allegation of negligence.<sup>41</sup> The court held that negligent as well as intentional misrepresentations are within the ambit of rule 10b-5.<sup>42</sup>

This position was apparently adopted by the majority in *SEC v. Texas Gulf Sulphur Co.*<sup>43</sup> The Court of Appeals for the Second Circuit

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*Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14, 23 (W.D. Ky. 1960), *rev'd on other grounds sub nom.*, *Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962).

<sup>35</sup> *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Stevens v. Vowell*, 343 F.2d 374, 379-80 (10th Cir. 1965); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963).

<sup>36</sup> [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶92,290 (S.D. Tex. 1968).

<sup>37</sup> *Id.* ¶92,290 at 97,388.

<sup>38</sup> 282 F. Supp. 94 (N.D. Ill. 1967).

<sup>39</sup> Brief for Defendant, Peat, Marwick, Mitchell & Co., at 8, *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967).

<sup>40</sup> 282 F. Supp. at 102.

<sup>41</sup> *Id.* at 104.

<sup>42</sup> *Id.* at 105.

<sup>43</sup> 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

in deciding this case cited both *Fischman* and *Ellis* in support of the proposition that negligent misrepresentations or omissions are actionable under rule 10b-5:

In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful. A similar standard has been adopted in private actions . . .

. . . [T]his position is not . . . irreconcilable with previous language in this circuit because "some form of the traditional scienter requirement" . . . *Fischman v. Raytheon Mfg. Co.*, . . . is preserved. This requirement, whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule.<sup>44</sup>

As the above discussion indicates, this interpretation is at best a somewhat loose reading of *Ellis* and *Fischman*. To compound the confusion, the majority later in its opinion indicated that good faith will be a defense to a private action instituted under rule 10b-5 for misrepresentation in the purchase or sale of securities:

It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, rule 10b-5 would not have been violated.<sup>45</sup>

Further, the concurring opinions express reservations about imposing civil liability for negligence.<sup>46</sup>

Coupling these observations with the fact that *Texas Gulf Sulphur* involved governmental enforcement rather than a private action, it seems clear that the decision affords no real answer to the scienter question. This conclusion is borne out by the subsequent decisions that contain discussions of the language of *Texas Gulf Sulphur*. The majority of the courts in these cases recognize scienter as an element in a private action under the Rule, but are not specific as to the degree of scienter.<sup>47</sup>

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<sup>44</sup> *Id.* at 854-55.

<sup>45</sup> *Id.* at 862.

<sup>46</sup> *Id.* at 866, 868, 869.

<sup>47</sup> See, e.g., *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969); *Ruszkowski v. Hugh Johnson & Co., Inc.*, 302 F. Supp. 1371 (W.D.N.Y. 1969);



The following excerpt from *Astor v. Texas Gulf Sulphur*<sup>48</sup> is representative:

While some degree of scienter is required, "the trend is clearly away from enforcing a scienter requirement equal to the 'intent to defraud' required for common law fraud." *Globus v. Law Research Service* [418 F.2d at 1291]. What degree is necessary, whether it is "actual knowledge of falsity," *Heit v. Weitzen*, 402 F.2d 909, 914 (2d Cir. 1968), or "recklessness . . . equivalent to wilful fraud," *S.E.C. v. Texas Gulf Sulphur*, . . . is not entirely clear. Until the "great debate over ordinary negligence versus scienter in private actions under 10(b) and Rule 10b-5," *Globus v. Law Research Service* [418 F.2d at 1291], is resolved, this court will adhere to the most recent views expressed by this Circuit, that plaintiffs must show more than that the April 12 press release was negligently prepared. They must show some degree of scienter.<sup>49</sup>

Professor Bromberg has stated the view that the trend in case law is very much against requiring scienter in a private action under rule 10b-5;<sup>50</sup> a writer in the *North Carolina Law Review* has observed a contrary development taking place.<sup>51</sup> With due respect to both, it seems inaccurate to view these few decisions as representing any sort of trend. In most circuits, the necessity of alleging and proving a particular state of mind in a rule 10b-5 action has not even been discussed by way of dictum. Thus, as Professors Jennings and Marsh have observed, any trend as to the necessity of proving scienter in a 10b-5 action "would appear to be largely in the eye of the beholder."<sup>52</sup>

Legal writers are as divided on the question of what the "law" should be<sup>53</sup> as they are on the question of what the present state of the law is. To mention but a few of the ideas that have recently appeared: Professor

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*Gerstel v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969). *But cf.* *Reynolds v. Texas Gulf Sulphur Co.*, CCH FED. SEC. L. REP. ¶ 92,494 (D. Utah Oct. 17, 1969) (civil liability imposed with no discussion of elements of private action).

<sup>48</sup> 306 F. Supp. 1333 (S.D.N.Y. 1969).

<sup>49</sup> *Id.* at 1343-44.

<sup>50</sup> BROMBERG § 2.6(1).

<sup>51</sup> Comment, *Securities Regulation—Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems*, 46 N.C.L. REV. 599, 625 (1968).

<sup>52</sup> R. JENNINGS & H. MARSH, *supra* note 17, at 866-67 n.6.

<sup>53</sup> The shorthand phrase "what the 'law' should be" is perhaps misleading. Many legal commentators favor the replacement of 10b-5 with a comprehensive provision for civil liability. See Henkel, *Codification—Civil Liability Under the Federal Securities Laws*, 22 BUS. LAWYER, 866 (1967). The views surveyed in the text, however, refer to the role of scienter in rule 10b-5 in its present form.

Meisenholder advocates requiring scienter;<sup>54</sup> Professor Jennings agrees except when plaintiff and defendant were in a fiduciary-type relationship;<sup>55</sup> Professor Loss would require at least "watered down scienter";<sup>56</sup> Professor Israels would extend liability to include negligent misrepresentation;<sup>57</sup> and most recently Professor Ruder has proposed a variable standard of state of mind dependent upon privity, trading, and whether the gravamen of the complaint is misrepresentation or merely nondisclosure.<sup>58</sup>

As the cases and commentators provide no clear answer to the role of scienter in private actions under rule 10b-5, it is necessary to examine the Rule in light of recognized constructional principles.

### III. CONSTRUCTIONAL ARGUMENTS

The construction of a statute or rule is, at best, an inexact art. Professor Newman has stated:

[T]he cases lack consistency. The Court at times stresses words; at times, intent. Maxims of construction compete with considerations of policy. . . . The issues have been so scattered that we cannot even detect trends.<sup>59</sup>

There is, however, agreement that the initial step in the constructional process is an examination of the language of the rule itself.<sup>60</sup>

#### A. Language of the Rule

Professor Painter has observed that "[t]he fertility of rule 10b-5 lies in its potential to prohibit as much as possible while saying as little

<sup>54</sup> Meisenholder, *Scienter and Reliance as Elements in Buyer's Suit Against Seller Under Rule 10B-5*, 4 CORP. PRAC. COMM. 27 (Feb. 1963). *Accord*, M. Katz & D. Schwartz, *Civil Liability Under Rule 10b-5*, in PLI, SEC PROBLEMS (1967); Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965).

<sup>55</sup> Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5*, 62 NW. U.L. REV. 809, 818 (1968).

<sup>56</sup> 3 Loss 1766. *Accord*, Comment, *Securities Regulation: Shareholder Derivative Actions Against Insiders Under Rule 10b-5*, 1966 DUKE L.J. 166, 171-72; Comment, *Private Remedies Available Under Rule 10b-5*, 20 SW. L.J. 620, 621 (1966).

<sup>57</sup> Israels, Book Review, 77 YALE L.J. 1585, 1593 (1968). *Accord*, Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965).

<sup>58</sup> Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423, 444 n.107 (1969).

<sup>59</sup> Newman, *How Courts Interpret Regulations*, 35 CALIF. L. REV. 509, 522 (1947).

<sup>60</sup> See generally E. CRAWFORD, *THE CONSTRUCTION OF STATUTES* § 164 (1940).

as possible.”<sup>61</sup> The Rule makes no mention of scienter. It provides that it shall be unlawful for any person directly or indirectly by use of interstate commerce, the mails, or the facilities of a national securities exchange:

- (a) To employ any device, scheme or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . .<sup>62</sup>

The phrase “to defraud” in clause (a) implies a requirement of scienter.<sup>63</sup> “[O]perate as a fraud or deceit upon any person” in clause (c) can be similarly read.<sup>64</sup> There is, however, no language in clause (b) that gives rise to even an implication that scienter may be required. Because of this interpretation, several legal writers have taken the position that the scienter requirement differs from clause to clause—that it is required under clauses (a) and (c), but not under clause (b).<sup>65</sup> For this suggestion to have any practical significance, it is necessary that clause (b) operate in an area separate and distinct from that of clauses (a) and (c).

The Securities and Exchange Commission regards the clauses as “mutually supporting rather than mutually exclusive.”<sup>66</sup> Similarly, most courts and commentators have made no effort to distinguish the clauses.<sup>67</sup>

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<sup>61</sup> Painter, Book Review, 21 VAND. L. REV. 612 (1968).

<sup>62</sup> 17 C.F.R. § 240.10b-5 (1969).

<sup>63</sup> See *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 770 (D. Colo. 1964).

<sup>64</sup> W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* 230 (1968); 82 HARV. L. REV. 938, 947 (1969). But see Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 826 (1965) (“‘operate as a fraud’ emphasizes the effect of the conduct rather than the actor’s state of mind.”)

<sup>65</sup> See, e.g., Groff, *Securities and Exchange Commission v. Texas Gulf Sulphur—Confidential Information and Insider Trading—Rule 10b-5 Emerges into the Spotlight*, 1966 CORP. COUNSEL ANN. 242, 252; Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U.L. REV. 541, 549, 561 (1968).

<sup>66</sup> Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961).

<sup>67</sup> E.g., *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962) (by implication); Comment, *Securities Regulation—Fraud in Securities Transactions and Rule 10b-5—A Survey of Selected Current Problems*, 46 N.C.L. REV. 599, 623-25 (1968); Comment, *Private Remedies Available Under Rule 10b-5*, 20 SW. L.J. 620, 621 (1966).

A writer in the *University of Chicago Law Review*, however, has suggested that since clause (b) speaks more directly to active misrepresentations, "it should be the principal enforcement clause for such conduct."<sup>68</sup> No court has taken this position, and no reported decision contains any attempt to distinguish the types of conduct covered only by clause (b).<sup>69</sup> On the contrary, in *SEC v. Capital Gains Research Bureau, Inc.*,<sup>70</sup> the Supreme Court took the opposite view in construing the anti-fraud provision of the Investment Advisers Act of 1940,<sup>71</sup> which is worded virtually the same as clauses (a) and (c) of rule 10b-5. Noting the omission of a counterpart to clause (b), the Court found that fact to have no practical significance<sup>72</sup> and labelled "a specific proscription against non-disclosure surplusage."<sup>73</sup>

Thus, it would seem that the following conclusions can be drawn from considering the language of rule 10b-5: (1) the scienter requirement should be the same for each of the clauses of rule 10b-5, and (2) while the Rule is ambiguous, there is language that can be construed as requiring some form of scienter.

### B. Language of Section 10b

To be valid, an administrative regulation must be within the ambit of the enabling statute.<sup>74</sup> Section 10b of the Securities Exchange Act<sup>75</sup> authorizes rules and regulations proscribing "any manipulative or deceptive device." Professor Loss has suggested that this language may limit the Securities and Exchange Commission's authority under section 10b to the promulgation of rules requiring scienter and that if rule 10b-5 is not so limited, it is ultra vires.<sup>76</sup> There is case law supporting this proposition;<sup>77</sup> however, there is also contrary authority.

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<sup>68</sup> Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 826 (1965). Cf. Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAWYER 939, 944-45 (1962).

<sup>69</sup> Some courts have, however, suggested that total silence may violate only clauses (a) and (c). See, e.g., *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 767 (D. Colo. 1964); *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S.D.N.Y. 1962). Accord, 3 Loss 1439.

<sup>70</sup> 375 U.S. 180 (1963).

<sup>71</sup> 15 U.S.C. § 80b-6(1), (2) (1964).

<sup>72</sup> 375 U.S. at 197-99.

<sup>73</sup> *Id.* at 199.

<sup>74</sup> *Yarborough v. Gardner*, 283 F. Supp. 814, 821 n.6 (E.D.N.C. 1968).

<sup>75</sup> 15 U.S.C. 78j(b) (1964).

<sup>76</sup> 3 Loss 1766. Accord, 82 HARV. L. REV. 938, 947 (1969).

<sup>77</sup> E.g., *Richland v. Crandall*, 262 F. Supp. 538, 553 n.12. (S.D.N.Y. 1967); *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 772 (D. Colo. 1964).

In rejecting the proposition, the court in *Ellis v. Carter*<sup>78</sup> emphasized the word "any":

We see no reason to go beyond the plain meaning of the word 'any,' indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden, to construe the statute as if it read 'any fraudulent' devices.<sup>79</sup>

This reasoning is at best questionable. Granted that "any" manipulative or deceptive device means manipulative or deceptive devices of whatever kind,<sup>80</sup> the question remains whether every kind of manipulative or deceptive device requires scienter.

Professor Meisenholder has reached the same result as the court in *Ellis* in a more logical manner by focusing on the word "deceptive" and defining it to include "misrepresentations and omissions of material facts which are misleading, no matter how innocently made."<sup>81</sup> Similarly, a California appellate court in *People v. Wahl*,<sup>82</sup> in construing a statute prohibiting "deceptive or misleading [advertising],"<sup>83</sup> relied on a dictionary definition—"deceptive does not always imply intent to deceive"<sup>84</sup>—to find no scienter requirement. A writer in the *Yale Law Journal* has taken the position that the omission from section 10b of any specific language requiring intent indicates that conduct may be manipulative or deceptive without being intentional.<sup>85</sup>

Both lines of authority have ignored a relevant consideration—the similar language in section 15(c)(1)<sup>86</sup> of the same Act. This subsection prohibits brokers or dealers from effecting transactions "by means of a manipulative, deceptive, or other fraudulent device or contrivance." The word "other" is the key. Such a use of "other" in a statute means that

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<sup>78</sup> 291 F.2d 270 (9th Cir. 1961).

<sup>79</sup> *Id.* at 274.

<sup>80</sup> *But see* *Donohue v. Zoning Bd. of Appeals*, 155 Conn. 550, 556, 235 A.2d 643, 646 (1967) ("any" does not necessarily mean "all" or "every").

<sup>81</sup> Meisenholder, *supra* note 54, at 37. Cf. Leavell, *The Texas Gulf Sulphur Opinion in the Appellate Court: An Open Door to Federal Control of Corporations*, 3 GA. L. REV. 141, 159 (1968).

<sup>82</sup> 39 Cal. App. 2d 771, 100 P.2d 550 (L.A. County Super. Ct., App. Dept. 1940).

<sup>83</sup> Ch. 254, § 1, [1905] Cal. Stat. 227, as amended, ch. 634, § 1, [1915] Cal. Stat. 1027 (repealed 1941).

<sup>84</sup> 39 Cal. App. 2d at 772, 100 P.2d at 551, quoting WEBSTER'S NEW INTERNATIONAL DICTIONARY (1938). *Webster's Third New International Dictionary* omits any such mention.

<sup>85</sup> Note, *Civil Liability Under Section 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 683 (1965).

<sup>86</sup> 15 U.S.C. 78o(c)(1) (1964).

the words preceding it are of the same character as the words following it.<sup>87</sup> Thus, "other" indicates that "manipulative" and "deceptive" come within the meaning of "fraudulent," and, as pointed out above, "fraudulent" is generally regarded as requiring scienter.<sup>88</sup>

It is a well-recognized principle of statutory construction that when the same word is used in different parts of the same statute, it will be presumed to be used in the same sense in each place, at least in the absence of anything in the statute indicating a contrary intent.<sup>89</sup> Accordingly, if "deceptive" is synonymous with "fraudulent" in section 15, it should be synonymous with "fraudulent" in section 10.

The language of section 20c of the Investment Advisers Act<sup>90</sup> may also be relevant. It prohibits conduct that is "fraudulent, deceptive or manipulative." The use of the disjunctive pronoun "or" seems to indicate that "manipulative" and "deceptive" are different from "fraudulent."<sup>91</sup> The Supreme Court, however, has taken a contrary position; in construing this provision, the Court said that "manipulative" is no broader than "fraudulent."<sup>92</sup>

### C. Statutory Tort—"Willfully"

In *Kardon v. National Gypsum Co.*,<sup>93</sup> the first case to recognize civil liability under rule 10b-5, the court relied in part on the statutory tort theory.<sup>94</sup> Under this theory, the violation of a criminal statute results in civil liability. Rule 10b-5 is not itself a criminal statute; nor is section 10b. There are no provisions for criminal sanctions in either. Section 32<sup>95</sup> of the Securities Exchange Act of 1934, however, does make criminal any *willful* violation of any section of the Act or of any rule promulgated thereunder. Accordingly, a *willful* violation of rule 10b-5 is a criminal offense and civil liability can be implied therefrom.<sup>96</sup>

<sup>87</sup> E.g., *In re Bush Terminal Co.*, 93 F.2d 659, 660 (2d Cir. 1938); *Twin Falls County v. Hulbert*, 66 Idaho 128, 140, 156 P.2d 319, 324 (1945).

<sup>88</sup> See pp. 484-85 & note 19 *supra*.

<sup>89</sup> E.g., *United States v. Gertz*, 249 F.2d 662, 665 (9th Cir. 1957); *Arizona State Tax Comm'n v. Staggs Realty Corp.*, 85 Ariz. 294, 298, 337 P.2d 281, 284 (1959) (dictum).

<sup>90</sup> 15 U.S.C. § 80b-6(4) (1964).

<sup>91</sup> But see E. CRAWFORD, *THE CONSTRUCTION OF STATUTES* § 188 (1940) ("or" may mean "and").

<sup>92</sup> *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

<sup>93</sup> 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>94</sup> See generally Note, *Implying Civil Remedies from Federal Regulatory Statutes*, 77 HARV. L. REV. 285 (1963).

<sup>95</sup> 48 Stat. 904 (1934), as amended, 15 U.S.C. 78ff(a) (1964).

<sup>96</sup> The statutory tort theory is generally used to establish breach of duty in a

Based on this analysis, it can be argued that civil liability exists only for willful violations of 10b-5 and that the violation is willful only when the violator acts with scienter. Such an argument ignores the other basis for civil liability set out in *Kardon*,<sup>97</sup> more important for present purposes, it ignores the variety of meanings that have been attributed to the word "willful." While the majority of courts still define "willful" in terms such as "with evil intent or malice" or "bad purpose,"<sup>98</sup> there are courts that speak of "willful" as meaning "careless disregard"<sup>99</sup> or "reckless disregard for the safety of others."<sup>100</sup>

Even within the limits of the federal securities laws, the meaning of the word "willful" is far from clear.<sup>101</sup> In the very same sentence of section 32 that contains the word "willfully," the phrase "willfully and knowingly" appears. This fact would seem to indicate that "willfully" as used in section 32 means something different from, and less than, "knowingly." Further, while there has been no reasoned discussion of "willfully" under section 32, the courts have been liberal in construing this term in cases arising under other sections of the Securities Acts. In *United States v. Benjamin*,<sup>102</sup> for example, the Second Circuit indicated that the defendant acted willfully, within the meaning of section 24 of the Securities Act of 1933, when he "recklessly stated as facts things of which he was ignorant."<sup>103</sup> It would thus seem that the Second Circuit would label the actions of a defendant that fall within Class Three of Dean

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negligence action. See W. PROSSER, *LAW OF TORTS* § 35 (3d ed. 1964). The principle is, however, by no means so limited. See Joseph, *Civil Liability Under Rule 10b-5—A Reply*, 59 NW. U.L. REV. 171, 172-74 (1964). But cf. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 631-35 (1963).

<sup>97</sup> The court in *Kardon* also relied on contractual voidability under section 29(b), which provides that contracts in violation of any section of the Act shall be void. The court said: "[A] statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it." 69 F. Supp. at 514. Private actions can be grounded on this contractual theory only if the parties are in privity. Cf. 3 Loss 1759.

<sup>98</sup> E.g., *Chow Bing Kew v. United States*, 248 F.2d 466, 471 (9th Cir.), cert. denied, 355 U.S. 889 (1957); *Shields v. State*, 184 Okla. 618, 620-22, 89 P.2d 756, 760-61 (1939).

<sup>99</sup> *Brown v. Bullock*, 294 F.2d 415, 420 (2d Cir. 1961). The court also recognized that "willful" would embrace "an act done with a bad purpose." *Id.*

<sup>100</sup> *Kelly v. Burtner*, 310 Ill. App. 251, 256, 33 N.E.2d 754, 757 (1941).

<sup>101</sup> See generally 2 Loss 1307-12; 5 *Id.* 3367-78 (1969).

<sup>102</sup> 328 F.2d 854 (2d Cir.), cert. denied, 377 U.S. 953 (1964).

<sup>103</sup> 328 F.2d at 862. Alternatively, the court said: "[T]he government can meet its burden by proving that a defendant deliberately closed his eyes to facts he had a duty to see . . . ." *Id.*

Keeton's categories<sup>104</sup> as "willful." Other courts have gone even further, bringing negligent misrepresentations within the term "willfully." Both the Sixth<sup>105</sup> and Seventh Circuits<sup>106</sup> have held that the willfulness requirement of the Securities Act is satisfied by proof that the defendant made representations that due diligence would have shown to be untrue. This interpretation has led Professor Ruder to state that "this burden [proof of willfulness] will easily be met"<sup>107</sup> and a student author to write that "willfulness might be simply an alternative way of describing a negligence standard."<sup>108</sup>

#### *D. Legislative and Administrative History*

It is common when construing a statute that is ambiguous on its face to refer to legislative history as an aid in determining legislative intent.<sup>109</sup> Although a number of courts, faced with questions concerning the role of scienter in a private action under 10b-5, have discussed the legislative history of section 10b and rule 10b-5,<sup>110</sup> none has found any guidance. In enacting section 10b, Congress did not consider the possibility of private actions being maintained thereunder, much less the elements of such actions. Section 10b was enacted to give the newly created Securities and Exchange Commission the power to regulate manipulative practices so as to avoid loopholes in the law.<sup>111</sup> At the time of its enactment, the provision was generally regarded as of little significance.

Similarly, the history of rule 10b-5 affords little insight. It too was designed for use by the Securities and Exchange Commission, rather than as a basis for private recovery. In fact, the Commission in drafting

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<sup>104</sup> With respect to this and subsequent references Dean Keeton's five classes of misrepresentation, see pp. 483-84 *supra*.

<sup>105</sup> See *Stone v. United States*, 113 F.2d 70, 75 (6th Cir. 1940).

<sup>106</sup> See *United States v. Schaefer*, 299 F.2d 625, 629 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962), *quoting Stone v. United States*, 113 F.2d 70, 75 (6th Cir. 1940).

<sup>107</sup> Ruder, *supra* note 96, at 678 n.231.

<sup>108</sup> Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 838 (1965).

<sup>109</sup> See generally 2 J. SUTHERLAND, STATUTORY CONSTRUCTION 481-507 (3d ed. 1943).

<sup>110</sup> See, e.g., *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964).

<sup>111</sup> S. REP. No. 792, 73d Cong., 2d Sess. 6 (1934). See *Hearings on H.R. 7852 and H.R. 8720 (Stock Exchange Regulation) Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (testimony of Thomas G. Corcoran).



and adopting rule 10b-5 was motivated by a specific incident—a corporate officer was intentionally spreading erroneous harmful information about his company so that he could purchase its outstanding stock at a greatly reduced price. In the words of the Rule's draftsman:

. . . I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be . . . .

We called the Commission and we got on the calendar . . . . All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.<sup>112</sup>

There was again little recognition of the significance of the action.<sup>113</sup> In a release issued on the day of adoption, the SEC explained the purpose and scope of the Rule as follows:

The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase. . . .<sup>114</sup>

Perhaps some significance can be attributed to the use of the word "fraud" by both Commissioner Pike and the writer of the press release.<sup>115</sup> While there is again the question of what is meant by "fraud," this phraseology would seem to indicate that the Commission viewed rule 10b-5 as applying to, at most, misrepresentations within Classes Three, Four, and Five. It is well to remember, however, that these observations were directed to governmental use of the Rule.<sup>116</sup>

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<sup>112</sup> Freeman, *Administrative Procedures*, 22 BUS. LAWYER 891, 922 (1967).

<sup>113</sup> See BROMBERG § 2.2; Manne, *In Defense of Insider Trading*, 44 HARV. BUS. REV. 113, 121 (Nov.-Dec. 1966).

<sup>114</sup> SEC Securities Exchange Act Release No. 3230 (May 21, 1942).

<sup>115</sup> The word "fraud" was also used in connection with rule 10b-5 in the Annual Report of the Securities and Exchange Commission for the year of the Rule's adoption. 8 SEC ANN. REP. 10 (1942).

<sup>116</sup> See, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963); Cady, Roberts & Co., 40 S.E.C. 907, 914-15 (1961); Bromberg, *Insider Purchases, Sales and Tips*, in PLI, TEXAS GULF SULPHUR—DISCLOSURES & INSIDERS 73 (1968).

*E. Significance of Other Sections of the Securities Acts*

Still another cardinal rule of statutory construction is that an interpretation making every section operative is favored over one that makes some sections duplicative or unnecessary.<sup>117</sup> There are several provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934, aside from section 10b and rule 10b-5, that provide for or have been read to provide for civil liability; there are also express statutory limitations on actions brought under these sections.<sup>118</sup> Consequently, it can be argued that unless these limitations are read into 10b-5 or unless liability under the Rule is limited to intentional misrepresentations, these sections will become surplusage since the plaintiff will always proceed under rule 10b-5 to avoid the limitations. To appreciate this contention fully, it becomes necessary to examine the sections referred to.

The Securities Act<sup>119</sup> contains three sections that expressly provide buyers of securities with a civil remedy for misrepresentation, and a fourth that has been so read. Section 11<sup>120</sup> imposes liability on "almost anyone who had anything to do with a new issue"<sup>121</sup> for false statements or omissions in the prospectus. Neither scienter nor negligence is necessary for the plaintiff's prima facie case under section 11; he need simply establish that he acquired securities whose registration statement contained a material misstatement or omission. State of mind, however, may be important to the defendant. Unless he is an issuer, he may avoid liability for the "unexpertized" portion of the registration statement<sup>122</sup> by estab-

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<sup>117</sup> [W]here the statute in question expressly created a private cause of action, the implied cause . . . must square with legislative intent at least to the extent that the implied private cause of action does not have aspects inconsistent with those provided in connection with the express cause.

Leavell, *supra* note 81, at 156.

<sup>118</sup> See generally Simpson, *Investors' Civil Remedies Under the Federal Securities Laws*, 12 DEPAUL L. REV. 71 (1962).

<sup>119</sup> An analysis of the Securities Act of 1933 is in order since the Securities Act and the Securities Exchange Act are generally regarded as being *in pari materia*. See, e.g., 3 LOSS 1781; Note, *Securities Acts—Securities Act of 1933—Buyer Relying on Misleading Prospectus May Recover Punitive Damages; Grossly Negligent Underwriter Cannot Enforce Indemnification Agreement Against Issuer*, 82 HARV. L. REV. 951, 954-59 (1969).

<sup>120</sup> 15 U.S.C. § 77k (1964).

<sup>121</sup> Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1126 (1950). For a more extensive discussion of liability under section 11, see Comment, *Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act*, 44 YALE L.J. 456, 470-76 (1935).

<sup>122</sup> For the "expertized" portion of the registration statement—that part certified by an expert such as an accountant—the defendant need establish only that

lishing that he had "reasonable ground to believe and did believe" that the statement in issue was true or that there was no omission of a material fact; the standard of reasonableness is statutorily defined as that required of a prudent man in the management of his own property. In terms of Dean Keeton's classifications, by bringing himself within Classes One or Two, the defendant avoids liability.

Section 12(2)<sup>123</sup> also provides relief for misstatements and omissions, but unlike section 11, the misstatements or omissions need not have occurred in the registration statement; they may be in any oral communication or prospectus.<sup>124</sup> As with section 11, scienter and negligence are a part of the defendant's case; by establishing that he did not know and in the exercise of "reasonable care" could not have known of the misrepresentation or omission, the defendant may avoid liability.<sup>125</sup> Again, by bringing himself within Classes One or Two, the defendant is protected.

If an action is brought under either section 11 or section 12(2), the court in its discretion may require the plaintiff to post a bond for the payment of costs, including attorneys fees, in the event that the suit is found to be lacking merit.<sup>126</sup> The plaintiff under section 11 or 12(2) must allege facts establishing that the action has been brought within one year after the discovery of the omission or after such discovery should have been made by the exercise of reasonable diligence.<sup>127</sup> There are also venue limitations on private actions brought under section 11 or section 12(2); such actions must be instituted in the district in which the defendant is found, is an inhabitant, or transacts business or in the district in which the sale took place if the defendant participated in it.<sup>128</sup>

Section 15<sup>129</sup> imposes liability on one who controls, through stock

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"he had no reasonable ground to believe and did not believe . . . that the statements . . . were untrue . . ." 15 U.S.C. § 77k (1964).

<sup>123</sup> 15 U.S.C. § 77l(2) (1964).

<sup>124</sup> "Prospectus" is defined in section 2(10) of the Securities Act include virtually every written communication.

<sup>125</sup> The interpretation of this provision affords further illustration of the division over the meaning of scienter. Professor Loss has taken the position that scienter is "foreign" to section 12(2) while a Michigan notewriter has written: "This language incorporates . . . scienter into a section 12(2) action, but as an affirmative defense." Compare 3 Loss 1730 with Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070, 1074 (1965).

<sup>126</sup> 15 U.S.C. § 77k(e) (1964).

<sup>127</sup> 15 U.S.C. § 77m (1964). But in no event shall an action be allowed more than three years after sale or initial offering.

<sup>128</sup> 15 U.S.C. § 77v (1964). Actions may also be brought in state tribunals.

<sup>129</sup> 15 U.S.C. § 77o (1964).

ownership, agency, or otherwise, a person liable under section 11 or 12. The venue and costs provisions applicable to sections 11 and 12 also apply to section 15.<sup>130</sup> Again, the defendant has the burden of proving his state of mind—proof of “no knowledge of or reasonable ground to believe in” the existence of the facts giving rise to the asserted liability constitutes a defense. This standard seems more favorable to the defendant than those in sections 11 and 12. In terms of Dean Keeton’s classifications, only those persons in Classes Four or Five would seem to be vulnerable under section 15.

Some courts have recognized a private right of action in a buyer for misrepresentations under section 17.<sup>131</sup> Section 17 is worded virtually the same as rule 10b-5; the rule was, in effect, copied from it.<sup>132</sup> It would thus seem that the scienter requirements under section 17 should be the same as under rule 10b-5, and several courts have taken this position.<sup>133</sup> Accordingly, there will be no separate discussion of this section.

Remedies under the Securities Exchange Act, unlike those under the Securities Act, are available to both buyers and sellers. Like the Securities Act, the Securities Exchange Act contains three sections that expressly provide for civil liability for misrepresentation and, again, a fourth that has been so read.

Section 9 of the Act contains a number of specific prohibitions against the manipulation of securities registered on a national exchange. One such prohibition goes to a false and misleading statement that the misrepresenter “knew or had reasonable grounds to believe was false or misleading.”<sup>134</sup> This standard seemingly encompasses only Classes Four

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<sup>130</sup> There is, however, some question as to the applicable statute of limitations. Section 13, the limitations provision of the 1933 Act, speaks only of sections 11 and 12. It can, however, be argued that since liability under section 15 extends only “to the same extent as” liability under sections 11 and 12, section 13 also applies to section 15.

<sup>131</sup> *E.g.*, Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955); Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949). *Contra*, Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 769 (D. Colo. 1964). Professor Loss has made a telling argument against implying a private action under section 17 by pointing out that the Securities Act is replete with express remedies for the same activities. 3 Loss 1784-90. Nevertheless, this controversy seems of limited practical significance in light of the implied private remedy under rule 10b-5.

<sup>132</sup> See p. 497 & note 112 *supra*.

<sup>133</sup> *E.g.*, Fischman v. Rathen Mfg. Co., 188 F.2d 783, 787 n.2 (2d Cir. 1951) (dictum); Globus v. Law Research Serv., Inc., 287 F. Supp. 188 (S.D.N.Y. 1968).

<sup>134</sup> 15 U.S.C. § 78i(a) (4) (1964).

and Five;<sup>135</sup> it cannot be said that a person with no knowledge of the accuracy or inaccuracy of his statement has reasonable grounds to believe that the statement is false. Section 9(e), however, limits civil liability for violation of the section to persons who "willfully" violate its mandates. It could be argued from this limitation that the potential defendants are limited to those within Class Five.<sup>136</sup> Defenses are available that limit the applicability of section 9 even further; not only are there venue and costs limitations similar to those under sections 11 and 12(2) of the Securities Act, but there is also a severe causation burden.<sup>137</sup>

Section 18<sup>138</sup> provides for civil liability for misleading statements of material facts in papers filed under the Securities Exchange Act or any rule thereunder. As in sections 11 and 12(2) of the Securities Act, the defendant has the burden of proving his state of mind as a defense. A defendant in an action under section 18 may avoid liability by establishing that he acted in good faith and without knowledge of the falsity or misleading nature of the statement. This standard has been generally considered as being very favorable to the defendant—much less stringent than, for example, section 11 of the 1933 Act.<sup>139</sup> Such a view, however, seems to focus only on the requirement of knowledge and to ignore the phrase "in good faith." Defendants within Classes Three and Four as well as those in Class Five are not "in good faith" and accordingly can not utilize this defense.

Section 20<sup>140</sup> is the Securities Exchange Act counterpart of section 15 of the Securities Act; it imposes liability on anyone who controls a person liable under any of the provisions of the 1934 Act. The defenses available to the defendants, however, are stated in terms different from those of section 15—"good faith" as contrasted with "knowledge of or reasonable grounds to believe." Although, for reasons mentioned above, the former would seem to protect only defendants in Classes One and

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<sup>135</sup> Professor Schulman apparently would limit it even further—to Class Five only. In referring to this language in section 9, he has written: "This 'scienter' requirement is a strict one and goes far beyond the more modern concepts applied in misrepresentation cases." Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion*, 13 WAYNE L. REV. 635, 646 (1967).

<sup>136</sup> Compare pp. 494-95 & notes 96-97 *supra*.

<sup>137</sup> See generally 3 Loss 1748-49.

<sup>138</sup> 15 U.S.C. § 78r (1964).

<sup>139</sup> 3 Loss 1752 ("cousin to scienter"); Comment, *Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act*, 44 YALE L.J. 456, 474 (1935) ("may enable the negligent or even the intentionally dishonest director or officer to escape liability entirely").

<sup>140</sup> 15 U.S.C. § 78t (1964).

Two and the latter defendants in Classes One through Three, the absence of case law under these sections precludes any certainty as to the practical differences between the two standards.<sup>141</sup>

Civil liability for misrepresentation has been implied from section 15(c)(1)<sup>142</sup> of the Securities Exchange Act—the anti-fraud provision applicable to over-the-counter transactions involving brokers or dealers.<sup>143</sup> Aside from the language limiting it to over-the-counter transactions by brokers or dealers, the wording of 15(c)(1) is markedly similar to that of section 10b. In addition, rule 15c(1-2), promulgated under section 15(c)(1), defines fraudulent practices in a manner similar in part to 10b-5(b) except that the misstatement must be made “with knowledge or reasonable grounds to believe that it is untrue or misleading.”<sup>144</sup> Unlike sections 11 and 12(2) of the Securities Act and section 18 of the Securities Exchange Act, the burden of proof is on the plaintiff; he must establish that the defendant comes within Classes Four or Five.

There is no statutory basis for applying any of the restrictions in the above provisions to rule 10b-5.<sup>145</sup> One example is the statute of limitations.<sup>146</sup> While a number of writers have urged that the statute of limitations of the Securities Act of 1933 should be implied in private actions brought under rule 10b-5,<sup>147</sup> no court to date has so held. Such a holding would ignore the statutory framework. Rule 10b-5 was promulgated under the Securities Exchange Act of 1934, which contains several limitations provisions. This fact would seem to preclude application of the 1933 Act's limitations to the Rule. On the other hand, the Securities Exchange Act's statutes of limitations are also not applicable; they are all directed to particular sections of the Act—sections other than section 10b.

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<sup>141</sup> Professor Loss indicates that the standards are different but does not state the nature of the difference. 3 Loss 1808.

<sup>142</sup> 15 U.S.C. § 78o(c)(1) (1964).

<sup>143</sup> See, e.g., *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 673 (S.D.N.Y.) (dictum), *aff'd per curiam*, 367 F.2d 157 (2d Cir. 1966). See also E. GADSBY, *FEDERAL SECURITIES EXCHANGE ACT* § 5.03(2), at 5-31 (1967).

<sup>144</sup> “This is a version of scienter . . .” BROMBERG §2.3, at 23.

<sup>145</sup> See Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 836 n.49 (1965).

<sup>146</sup> “[T]he main reason for bringing an action under section 10b and Rule 10b-5 may be to avoid the relatively short statute of limitations provided for in the express civil liability sections of the 1933 and 1934 Acts.” H. SOWARDS, *SECURITIES REGULATIONS* 436 (1966).

<sup>147</sup> See BROMBERG § 12.9, at 284; Israels, *supra* note 57, at 1591; Schulman, *supra* note 135; Note, *Civil Liability Under Section 10B and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 685-86 (1965).

Accordingly, a plaintiff can avoid the obstacles presented by other potentially applicable provisions of the Securities Act and the Securities Exchange Act by proceeding under rule 10b-5, and this is precisely what plaintiffs are doing.<sup>148</sup> Professor Bromberg has approximated that rule 10b-5 is "generating almost as much litigation as all the other general antifraud provisions together, and several times as much as the express liabilities,"<sup>149</sup> and has stated:

[Rule 10b-5] is by now such a dominant factor in private securities litigation that one is surprised when it does not turn up, and a court does not hesitate to introduce it as a major consideration if plaintiff fails to plead it.<sup>150</sup>

#### IV. CONCLUSION

While principles of statutory construction do not definitely establish which misrepresentations should be within the ambit of rule 10b-5, they do indicate which misrepresentations should not: those innocently made. Although actions based on intentional and negligent misrepresentations are consistent with the above considerations, actions based on innocent misrepresentations are not.

This conclusion is also supported by the policy underlying the federal securities legislation. The probable result of imposing liability under rule 10b-5 for innocent misrepresentations would be a drastic reduction of information to the public regarding traded securities; the basic purpose of the federal securities laws is to statutorily encourage and increase the dissemination of information pertaining to securities.<sup>151</sup> Thus it would be incongruous to extend rule 10b-5's coverage to innocent misrepresentations.

The question remains, however, whether rule 10b-5 reaches negligent as well as intentional misrepresentations—whether Classes Two through Five should all be actionable under the Rule. Constructional principles do not provide an answer. On balance, they indicate that such a reading of rule 10b-5 is permissible; however, they afford no guidance as to the policies that support such an interpretation. The desirability of subjecting negligent misrepresentations to liability under rule 10b-5 would seem to call for consideration by the SEC of the effects of such action on the flow of information to the public regarding securities. Attention should

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<sup>148</sup> Schulman, *supra* note 135, at 644.

<sup>149</sup> BROMBERG § 2.5(6), at 45-46.

<sup>150</sup> *Id.* 46.

<sup>151</sup> See *In re Tucker Corp.*, 26 S.E.C. 249 (1947). The preamble to the Securities Act reads in part: "To provide full and fair disclosure. . ."

be given to the quality as well as the quantity of such information. Obviously, the easier it is to establish liability for misrepresentations under the Rule, the more careful a representer will be in what he states, and the higher will be the quality of the information that is disseminated; equally obvious, the harder it is to establish liability for misrepresentations, the freer will be the flow of information although its quality or accuracy may suffer.

These conflicting goals present a question of policy that the SEC is best equipped to handle.<sup>152</sup> It is unrealistic to expect a legislative solution in the near future.<sup>153</sup> The same is true of a judicial solution. Some of the federal judicial circuits have yet to consider a private action under rule 10b-5; and in *SEC v. National Securities, Inc.*,<sup>154</sup> the Supreme Court said:

Although § 10b and Rule 10b-5 may well be the most litigated provisions in the federal securities laws, this is the first time this Court has found it necessary to interpret them. We enter this virgin territory cautiously. The questions presented are narrow ones. They arise in an area where glib generalizations and unthinking abstractions are major occupational hazards. Accordingly, in deciding this particular case, remembering what is not involved is as important as determining what is.<sup>155</sup>

Heeding the Court's admonition, no further "glib generalizations" will be made. Rather, SEC action in this area is again urged. As one of the nation's leading securities lawyers has observed: "[I]f the law were clearer and 10b-5 had been written out in some kind of a specific regulation and I think it is possible—I don't think Texas Gulf could have happened."<sup>156</sup>

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<sup>152</sup> See generally 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 1.05 (1958). But cf. Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423, 450 (1968) ("each case involves separate considerations which no longer lend themselves to sweeping statements regarding the elements required for imposition of liability under Rule 10b-5").

<sup>153</sup> See e.g., Demmler, *Codification*, 22 BUS. LAWYER 832, 840 (1967); Israels, *supra* note 57. It should be noted that Professor Loss has recently undertaken the task of recodifying federal securities laws for the American Law Institute.

<sup>154</sup> 393 U.S. 453 (1969).

<sup>155</sup> *Id.* at 465. This language would seem to render impractical Professor Ruder's proposal discussed at p. 490 *supra*. The variable factors in Ruder's plan necessitate a judicial rather than an administrative implementation.

<sup>156</sup> Panel Discussion—*The Emergence of Federal Corporation Law and Federal Control of Inside Information*, 34 U.M.K.C.L. REV. 228, 232 (1966) (remarks of Neil Kennedy).