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Aaron v. SEC: The Scienter Requirement in SEC Injunctive Actions

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AARON V. SEC: THE SCIENTER REQUIREMENT IN SEC INJUNCTIVE ACTIONS

The recent decision of the Supreme Court in *Aaron v. SEC*[1] is one whose immediate impact will be felt in all federal courts.[2] The Court in *Aaron* significantly altered the enforcement scheme of the anti-fraud provisions of the Securities Act of 1933 (1933 Act)[3] and the Securities Exchange Act of 1934 (1934 Act).[4] The question in *Aaron* was whether the Securities and Exchange Commission (SEC or Commission) is required to establish scienter[5] as an element of a civil enforcement action[6] to enjoin violations of sec-

1. 100 S. Ct. 1945 (1980).

2. A look at scienter in the Tenth Circuit follows at notes 15-45 *infra* and accompanying text.

3. 15 U.S.C. §§ 77a-77aa (1976).

4. 15 U.S.C. §§ 78a-78kk (1976).

5. The *Aaron* Court defined scienter as "an intent on the part of the defendant to deceive, manipulate, or defraud." 100 S. Ct. at 1950. This is in accordance with Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), which defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12. As in *Hochfelder*, the Supreme Court in *Aaron* reserved judgment whether scienter may be defined to include "reckless behavior." 100 S. Ct. at 1950 n.5.

The Tenth Circuit in the pre-*Hochfelder* decision of Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975), imposed a "scienter or conscious fault" requirement on a private party seeking money damages under 17 C.F.R. § 240.10b-5 (1980) (rule 10b-5). 507 F.2d at 1361-62. The Tenth Circuit has also ruled that a private plaintiff need only prove that the defendant was negligent. Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 521 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973). In 1976, the Supreme Court in *Hochfelder* concluded that a private cause of action for money damages will not lie under either § 10(b) of the 1934 Act or under rule 10b-5 in the absence of an allegation of scienter. 425 U.S. at 193.

Whether reckless conduct constitutes scienter in the Tenth Circuit has not been directly addressed by the court of appeals. *See, e.g.*, Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977). However, in Utah State Univ. of Agriculture & Applied Science v. Bear, Stearns & Co., 549 F.2d 164, 169 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977), the Tenth Circuit concluded that willful or intentional misconduct, or its equivalent, is an essential element under § 10(b) of the 1934 Act. Even in the face of *Bear, Stearns & Co.*, the Tenth Circuit nevertheless seems to have adopted a noncommittal position as to the scope of scienter. In the recent decision of Wertheim & Co. v. Codding Embryological Sciences, 620 F.2d 764 (10th Cir. 1980), the court noted:

> We recognize that recklessness has been held to be tantamount to *scienter* in some circumstances . . . . However, recklessness has been defined, in such context, as a frame of mind which comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence . . . . The trial court's determination that the [defendants] were only negligent negates the argument that they were guilty of reckless conduct, if indeed there was no actual intent to deceive.

Id. at 766-67 (citations omitted).

6. The Commission is expressly empowered under § 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), to seek injunctive relief:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter [*e.g.*, section 17(a)], or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

Similarly, § 21(d) of the 1934 Act, 15 U.S.C. § 78u(d) (1976), expressly authorizes the Commission to seek injunctive relief:

tion 17(a) of the 1933 Act,[7] section 10(b) of the 1934 Act,[8] and rule 10b-5,[9] promulgated under section 10(b).

The *Aaron* Court decided that section 10(b) of the 1934 Act[10] and section 17(a)(1) of the 1933 Act[11] are violated only when the defendant has acted with a willful intent to defraud. On the other hand, the *Aaron* Court held that sections 17(a)(2) and 17(a)(3) of the 1933 Act require no proof of scienter;[12] a finding of negligence is sufficient. The Court also concluded that because the SEC must prove some likelihood of a future violation before an injunction can issue,[13] "an important factor in this regard is the degree of intentional wrongdoing evident in a defendant's past misconduct."[14] This note will examine the state of the law before *Aaron*, the analysis employed by the *Aaron* Court, and the implications of this decision for the federal courts.

I. THE STATE OF MIND REQUIREMENT IN SEC INJUNCTIVE PROCEEDINGS: THE TENTH CIRCUIT

The question of whether the Commission[15] must show that the defendant in an injunctive proceeding acted with scienter has been fertile ground for commentary.[16] When examining the history of scienter as a necessary

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Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter [*e.g.*, § 10(b)], the rules or regulations thereunder [*e.g.*, rule 10b-5(1)] . . . it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

7. 15 U.S.C. § 77q(a) (1976). For the text of § 17(a), see note 31 *infra*.

8. 15 U.S.C. § 78j(b) (1976). For the text of § 10(b), see note 20 *infra*.

9. 17 C.F.R. § 240.10b-5 (1980). For the text of rule 10b-5, see note 20 *infra*.

10. 100 S. Ct. at 1954-55.

11. *Id.* at 1956.

12. *Id.*

13. *Id.* at 1959.

14. 100 S. Ct. at 1958. Chief Justice Burger went even further in his concurrence. The Chief Justice noted that it will "almost always be necessary" for the Commission to establish the defendant's intent to deceive before a court will issue an injunction. *Id.* at 1959.

15. This survey will limit itself to a consideration of the Commission, rather than private parties, as plaintiff. While the outcome of a private injunctive action is identical to that of an SEC injunctive proceeding, the elements of the action differ significantly. *See generally* Note, *Scienter and Injunctive Relief Under Rule 10b-5*, 11 GA. L. REV. 879, 880 n.9 (1977) [hereinafter cited as GA. L. REV.]. The Commission, because its injunctive power is a creature of statute, must seek its injunction under either § 20(b) of the 1933 Act or § 21(d) of the 1934 Act. (For the text of these sections, see note 6 *supra*). In contrast, the private plaintiff seeking an injunction must show both irreparable harm and the inadequacy of a remedy at law. The private injunctive action is judicially inferred; therefore, traditional equity principles apply. Ronbeau v. Mosinee Paper Corp., 422 U.S. 49, 57 (1975) (private injunction sought under § 13(d) of the 1934 Act); W. DE FUNIAK, HANDBOOK OF MODERN EQUITY 33-37 (1950). For an argument that the SEC and private injunctive actions should, as a matter of policy, contain the same requirements, see Note, Rondeau v. Mosinee Paper Corporation *and Implied Private Rights of Action*, 28 HASTINGS L.J. 93, 114 (1976).

16. *E.g.*, Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of* Hochfelder, 51 N.Y.U.L. Rev. 769 (1976); Harkleroad, *Requirements for Injunctive Actions under The Federal Securities Laws*, 2 J. CORP. L. 481 (1977); Lowenfels, *Scienter or Negligence Required for SEC Injunctions under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105 (Sp. Issue, Mar. 1975); Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After* Ernst & Ernst v. Hochfelder, 77 COLUM. L. REV. 419 (1977) [hereinafter cited as *The Scienter Requirement*]; Note, *Injunctive Relief in SEC Civil Actions: The Scope of Judicial*

element in an action for injunctive relief, it is important to note whether the case was decided before or after *Ernst & Ernst v. Hochfelder*.[17] In 1976, the Supreme Court concluded in *Hochfelder* that a private action for money damages will not lie under either section 10(b) of the 1934 Act or rule 10b-5 in the absence of an allegation of scienter.[18] The *Hochfelder* Court expressly declined, however, to decide whether proof of scienter is required in SEC injunctive proceedings for violations of section 10(b).[19]

A. *Pre-1976 Violations of Section 10(b) of the 1934 Act*[20]

Prior to *Hochfelder*, most courts that considered whether proof of any particular mental state was necessary in SEC injunctive actions for section 10(b) violations adopted a negligence standard.[21] Disagreement existed among the circuits, however, as to whether scienter or mere negligence was the appropriate standard in private damages actions.[22]

Discretion, 10 COLUM. J.L. & SOC. PROB. 328 (1974) [hereinafter cited as Note, *Judicial Discretion*]; GA. L. REV., *supra* note 15; Comment, *Scienter And SEC Injunctive Suits*: SEC v. Bausch & Lomb, Inc. *and* SEC v. World Radio Mission, Inc., 90 HARV. L. REV. 1018 (1977) [hereinafter cited as Comment, *SEC Injunctive Suits*]; *The Supreme Court, 1975 Term*, 90 HARV. L. REV. 255 (1976); Note, *SEC Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5; The Scienter Question*, 5 HOFSTRA L. REV. 831 (1977); and Note, *New Light on an Old Debate: Negligence v. Scienter in an SEC Fraud Injunctive Suit*, 51 ST. JOHN'S L. REV. 759 (1977) [hereinafter cited as *New Light on an Old Debate*].

17. 425 U.S. 185 (1976).

18. *Id.* at 193.

19. "Since this case concerns an action for damages we . . . need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5. *Cf.* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)." *Id.* at 194 n.12.

20. This discussion is limited to SEC injunctive actions alleging violations of § 10(b) of the 1934 Act or rule 10b-5. Section 10(b) of the 1934 Act makes it "unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest." 15 U.S.C. § 78j(b) (1976).

Under this section, the SEC promulgated rule 10b-5, which provides:

> It shall be unlawful for any person . . .
>
> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statements 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
>
> (3) 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 sale or purchase of any security.

17 C.F.R. § 240.10b-5 (1980).

For an examination of SEC proceedings based on § 17(a) of the 1933 Act, see notes 148-229 *infra* and accompanying text.

21. *See, e.g.*, SEC v. Management Dynamics, Inc., 515 F.2d 801, 809 (2d Cir. 1975); SEC v. Dolnick, 501 F.2d 1279, 1284 (7th Cir. 1974); SEC v. Spectrum, Ltd., 489 F.2d 535, 541 (2d Cir. 1973); and SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 (2d Cir. 1972). *See also* 1 A. BROMBERG, SECURITIES LAW § 2.6(1) (1975); Berner & Franklin, *supra* note 16, at 781-92; Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969).

The Sixth Circuit had a higher standard than that embraced by the Second, Seventh, and Tenth Circuits. SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *Coffey* stemmed from an SEC enforcement action based, in part, on § 10(b) of the 1934 Act and rule 10b-5. The court in *Coffey* decided that the Commission must prove that the defendants acted with a "wilful or reckless disregard for the truth." *Id.* at 1314.

22. *Compare* Woodward v. Metro Bank, 522 F.2d 84, 93 (5th Cir. 1975) (scienter required) *with* Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (mere negligence required). *Hochfelder* settled this disagreement.

The Tenth Circuit followed a dual approach that was initially developed in the Second Circuit.[23] In *Clegg v. Conk*,[24] the TenthCircuit ruled that "scienter or conscious fault" is required in a private action for money damages based on rule 10b-5.[25] In contrast, when the SEC sought to enjoin a fraudulent practice based, in part, on section 10(b) of the 1934 Act, the Tenth Circuit, in *SEC v. Pearson*,[26] concluded that "[p]roof of scienter or intent to defraud is not required to show violations justifying preliminary injunctive relief."[27] Similarly, the court in *SEC v. Geyser Minerals Corp.*[28] held that "[m]otive and intent, however, are not material in determining, in a[n] [SEC] civil injunctive suit, whether the defendants have violated the antifraud provisions of the 1933 Act and the 1934 Act [section 10(b)]. . . . The state of mind of the violators is not germane."[29] In sum, a pre-*Hochfelder* private plaintiff seeking money damages would have needed to prove scienter in the Tenth Circuit; however, if the Commission sought a statutory injunction it would not have been required to probe the state of the defendant's mind.

B. *Pre-1976 Violations of Section 17(a) of the 1933 Act*

Section 17(a), unlike section 10(b) and rule 10b-5,[30] applies only to *sellers* of securities.[31] The Seventh Circuit was confronted with a Commission injunctive proceeding based solely upon alleged violations of section 17(a) in *SEC v. G.N. Van Horn*.[32] The court reasoned that given the "plain language"[33] and the peculiar legislative history of section 17(a),[34] "under 17(a)(2) and (3) proof of scienter or fraudulent intent is not essential in a suit for injunctive relief."[35]

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23. *See generally New Light on an Old Debate*, *supra* note 16, at 765-68.

24. 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975). *See also* note 5 *supra*.

25. 507 F.2d at 1361-62. *See generally* Krendl & Krendl, *Securities, Second Annual Tenth Circuit Survey*, 53 DEN. L.J. 261 (1976).

26. 426 F.2d 1339 (10th Cir. 1970).

27. *Id.* at 1343. There is some confusion, however, as to whether *Pearson's* holding was rooted in section 10(b) of the 1934 Act or in section 17(a) of the 1933 Act. *See* notes 40-43 *infra* and accompanying text.

28. 452 F.2d 876 (10th Cir. 1971).

29. *Id.* at 880-81.

30. For the text of § 10(b) and rule 10b-5, see note 20 *supra*.

31. Section 17(a) of the 1933 Act provides:

> It shall be unlawful for any person in the offer or sale of any security by the use of any means . . .
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q (1976).

32. 371 F.2d 181 (7th Cir. 1966). In this case, the SEC also alleged violations of § 5 of the 1933 Act; however, § 5 is not relevant for the purposes of this survey. It is significant, however, that the Commission did not couple its § 17(a) claim with a § 10(b) allegation.

33. The text of § 17(a) of the 1933 Act is set forth in note 31 *supra*.

34. 371 F.2d at 185. For an extended discussion of the legislative history of § 17(a) of the 1933 Act, see notes 173-80 *infra* and accompanying text.

35. 371 F.2d at 186.

The Sixth Circuit stood alone in imposing a scienter standard in an SEC enforcement action as declared in *SEC v. Coffey*.[36] In *Coffey*, unlike the charges made in *Van Horn*, the Commission alleged violations of section 17(a) of the 1933 Act *and* section 10(b) of the 1934 Act and rule 10b-5 thereunder. Although a violation of section 17(a) was asserted by the Commission, the *Coffey* court focused on the language of section 10(b),[37] concluding that the legislature's use of the words "manipulative" and "deceptive" ruled out any liability for mere negligence[38]—regardless of the identity of the plaintiff.[39]

The Tenth Circuit addressed the culpability standard of section 17(a) of the 1933 Act in *SEC v. Pearson*,[40] a case in which the SEC sought to enjoin alleged securities violations based upon section 17(a)[41] and section 10(b) charges. Judge Holloway, speaking for the court, did not indicate whether section 17(a) or section 10(b) formed the analytical base for his conclusion that the SEC was not required to prove that the defendant acted with scienter.[42] *Pearson* did, however, cite the Seventh Circuit's decision in *Van Horn* as support for its conclusion.[43] Since the SEC had not asserted a section 10(b) violation in *Van Horn*, one can infer that *Pearson*'s holding is grounded solely on section 17(a).

As in *Pearson*, the Tenth Circuit case of *Geyser Minerals* involved securities violations based upon both section 17(a) and section 10(b).[44] Citing *Van Horn*, Judge Hamley in *Geyser Minerals* ruled that the SEC need not prove scienter in establishing securities violations under "the anti-fraud provisions of the 1933 Act [section 17(a)] *and* the 1934 Act [section 10(b)]."[45] *Van Horn* does support the Tenth Circuit's finding of a section 17(a) violation. Moreover, by linking the 1934 Act to the 1933 Act, Judge Hamley suggested that section 10(b) provides independent justification for a court's grant of an SEC

36. 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). See the discussion of *Coffey*, in the context of a § 10(b) violation, in note 21 *supra*.

37. The text of § 10(b) is found in note 20 *supra*.

38. 493 F.2d at 1314.

39. The Sixth Circuit, in *Coffey*, relied on the private damages action of Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973). The court reasoned that the statutory language that controlled in *Lanza* has equal force in an SEC injunctive proceeding. 493 F.2d at 1314.

Other circuits, by way of dicta, have dealt with the degree of culpability required under § 17(a) in an SEC injunctive proceeding. Each of the following cases contains dicta to the effect that § 17(a) does not impose the strict state-of-mind requirements of a common law fraud action for money damages: Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228, 233 (D.C. Cir. 1949) (Every element of common law fraud need not be proven to revoke a broker-dealer's registration.); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943) ("We need not stop to decide, however, how far common-law fraud was shown. For the business of selling investment securities has been considered one peculiarly in need of regulation for the protection of the investor."); Archer v. SEC, 133 F.2d 795, 799 (8th Cir. 1943) ("But the Commission is not bound by the strict common law rules as to the reception and consideration of such evidence.").

40. 426 F.2d 1339 (10th Cir. 1970).

41. *Id.* at 1340 n.1.

42. *Id.* at 1343.

43. *Id.* Judge Holloway also cited SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). *Capital Gains* involved an SEC action based on § 206(2) of the Investment Advisers Act. *Id.* at 181. An examination of *Capital Gains* is found at notes 124-47 *infra* and accompanying text.

44. 452 F.2d 876, 877 n.1 (10th Cir. 1971).

45. *Id.* at 880-81 (emphasis added).

request for a statutory injunction, even in the absence of any evidence of the defendant's intent to deceive.

II. *HOCHFELDER*: PRIVATE ACTIONS UNDER SECTION 10(B)

In *Ernst & Ernst v. Hochfelder*, a private plaintiff sought money damages from an accounting firm, charging that the defendant had conducted improper audits and, consequently, aided and abetted its client's violations of section 10(b) and rule 10b-5.[46] The plaintiff failed to allege that the defendant acted with scienter, and Justice Powell, speaking for the Court, found this omission fatal to the action.[47] Justice Powell rested the decision on three pillars: 1) the wording of section 10(b); 2) the legislative history surrounding the 1934 Act; and 3) the relationship of section 10(b) to the express civil remedies in the 1933 and 1934 Acts.

A. *The Text of Section 10(b)*

Looking to the language of section 10(b) as the starting point in statutory interpretation,[48] Justice Powell viewed the phrase "manipulative or deceptive device or contrivance" as clearly substantiating Congress' intent to impose liability only for "intentional misconduct."[49] The Court reasoned that whether the words were given their "commonly accepted meaning"[50] or read as "term[s] of art,"[51] the outcome was the same: Section 10(b) contemplates "conduct quite different from negligence."[52]

The Court found the statutory language so compelling that any court need look no further: "[M]indful that the language of a statute controls when sufficiently clear in its context, further inquiry may be unnecessary."[53] Nevertheless, the Court went on to examine whether a negligence standard for section 10(b) could be inferred from the legislative history of the 1934 Act.[54]

B. *The History of the 1934 Act*

While conceding that the legislative history surrounding the 1934 Act

46. 425 U.S. at 190. The plaintiff did not claim that the defendant aided and abetted any securities violations under § 17(a) of the 1933 Act. Moreover, *Hochfelder* expressly refrained from deciding whether civil liability for aiding and abetting a securities fraud exists under § 10(b) and rule 10b-5. *Id.* at 192 n.7. *See generally* GA. L. REV., *supra* note 15, at 883 n.18.

47. 405 U.S. at 193.

48. *Id.* at 197. The text of § 10(b) and rule 10b-5 appear at note 20 *supra*.

Justice Powell chose to follow his concurring opinion in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). ("The starting point in every case involving construction of a statute is the language itself." *Id.* at 756.). This represented a departure from the approach adopted in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). *Capital Gains* noted that securities statutes should be construed "flexibly to effectuate [their] remedial purposes." *Id.* at 186.

49. 425 U.S. at 197-98.

50. *Id.* at 199.

51. *Id.* Justice Powell noted that "manipulative" connoted "intentional or willful" deception of investors in the securities markets. *Id.*

52. *Id.*

53. *Id.* at 201.

54. *Id.*

was inconclusive as to the proper culpability standard,[55] the *Hochfelder* Court was satisfied that there was no congressional history to support the plaintiff's contention that section 10(b) was intended to impose liability for mere negligence.[56] The Court placed great weight on the comments of Mr. Corcoran, a spokesman for the drafters of the 1934 Act, who stated that section 10(b) was " 'a catch-all clause to prevent manipulative devices.' "[57] It appears, therefore, that it was not a case of the legislative history providing convincing support for the Court's literal reading of section 10(b), but rather it was the failure of the plaintiff to adduce legislative history supporting a contrary interpretation that proved decisive.[58]

C. *The Scheme of the Securities Laws*

The *Hochfelder* Court ruled that the 1933 and 1934 Acts are to be viewed as "interrelated components."[59] The Court then proceeded to point to the particularized culpability standards of the 1933 and 1934 Acts' civil liability provisions as evidence that mere negligent conduct would not support a section 10(b) private action. Justice Powell noted that when Congress wanted to create civil liability based on negligent conduct, it did so expressly.[60] As an example, the Court cited section 11(b)(3)(B) of the 1933 Act,[61] concerning the liability of experts for their misrepresentations in registration statements, and the associated availability of a due diligence defense.[62] The *Hochfelder* decision failed to explain, however, why the express creation of the scienter standard in section 9 of the 1934 Act would not, by the same reasoning, suggest a negligence culpability standard for section 10(b).[63]

In addition, the Court in *Hochfelder* drew a distinction between the judicially implied private damages action under section 10(b)[64] and the ex-

55. The Court noted that "the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress's intent . . . ." *Id.* at 201.

56. *Id.*

57. *Id.* at 202.

58. Justice Powell concluded by saying: "There is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catch-all provision of § 10(b) should be interpreted no more broadly." *Id.* at 206.

59. *Id.*

60. *Id.* at 208.

61. 15 U.S.C. § 77k (1976).

62. "The express recognition of a cause of action premised on negligent behavior in § 11 [of the 1933 Act, 15 U.S.C. § 77k] stands in sharp contrast to the language of § 10(b) . . . ." 425 U.S. at 208.

An expert's due diligence defense is a shorthand expression of the defense reflected in the language of § 11 itself. The expert may avoid civil liability by showing that "after a reasonable investigation" he had "reasonable ground[s] to believe" his statements were not materially misleading. *See, e.g.*, Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 697-703 (S.D.N.Y. 1968).

63. *See generally The Scienter Requirement*, *supra* note 16, at 422-28.

64. The existence of a private action for money damages based on § 10(b) or rule 10b-5 violations is now well settled. *E.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

Because it was the SEC, and not a private party, who sought the injunction in *Aaron*, the Supreme Court did not have "occasion to address the question whether a private cause of action exists under § 17(a) [of the 1933 Act]." 100 S. Ct. at 1951. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-34 n.6 (1975) (reserved for another a day a decision on an implied right to a private action under § 17(a) of the 1933 Act). Judge Doyle, in Trussel v.

pressly created civil liability provisions based upon a negligence standard.[65] The express remedies, sections 11,[66] 12(2),[67] and 15[68] of the 1933 Act, contain certain "procedural limitations;" namely, the posting of a bond for costs (including attorney's fees),[69] an authorization for the court to assess costs,[70] and a relatively short statute of limitations.[71] In contrast, a judicially created private damages action has no comparable limitations. If section 10(b) were extended to unintentional conduct, the Supreme Court argued, plaintiffs would bring their securities actions under section 10(b), instead of under sections 11, 12(2), and 15. This, of course, would nullify the procedural limitations Congress intended to place on the express actions.[72]

Lastly, *Hochfelder* addressed the ambit of rule 10b-5.[73] Justice Powell acknowledged that rule 10b-5 may be read to prohibit unintentional conduct.[74] Noting, however, the administrative history of the rule[75] and the authority of the SEC to promulgate rules under section 10(b),[76] the Court concluded that rule 10b-5 provided no basis for extending the reach of section 10(b) beyond intentional misconduct.[77]

United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964), concluded that there are no implied civil remedies under § 17(a).

65. 425 U.S. at 208-11.

66. 15 U.S.C. § 77k (1976).

67. 15 U.S.C. § 771(2) (1976). Section 12(2) imposes liability, based on a negligence standard, on a seller of securities who makes misrepresentations in connection with the sale.

68. 15 U.S.C. § 77o (1976). Under § 15, a "controlling person" is liable, under a negligence standard, for the violations of § 11 and § 12 committed by a controlled person.

69. Section 11(e), 15 U.S.C. § 77k(e) (1976), empowers a court to require a plaintiff suing under § 11, § 12(2), or § 15 of the 1933 Act to post a bond for the costs. This bond could prove to be an insurmountable hurdle, especially when attorney's fees are included. *See* Dabney v. Alleghany Corp., 164 F. Supp. 28 (S.D.N.Y. 1958).

70. In specified circumstances, § 11(e), 15 U.S.C. § 77k(e) (1976), also authorizes a court to assess costs at the conclusion of the litigation.

71. Section 13, 15 U.S.C. § 77m (1976), specifies that an action brought under § 11, § 12(2), or § 15 can be filed no later than one year from the time the violation was, or should have been, discovered. Regardless of the date of discovery, under no circumstances can the period exceed three years from the time of the offer or sale.

The statute of limitations for § 10(b) actions is governed by state law. *See generally* Raskin & Enyart, *Which Statute Of Limitations In A 10b-5 Action?*, 51 DEN. L.J. 301 (1974). The Tenth Circuit's position is that the state's fraud limitation period applies to 10b-5 claims. *Id.* at 313.

72. 425 U.S. at 210.

73. *Id.* at 212-14. The text of rule 10b-5 is found in note 20 *supra*.

74. "Viewed in isolation the language of [rule 10b-5(2)], and arguably that of [rule 10b-5(3)], could be read as proscribing . . . any course of conduct . . . whether the wrongdoing was intentional or not." 425 U.S. at 212.

75. *Id.* at 212-13 n.32. First, *Hochfelder* urged that rule 10b-5 was promulgated in "response to a situation clearly involving intentional misconduct." *Id.* at 212 n.32. Second, the Court stressed the use of the word "fraud" in the Commission's announcement of the rule. *Id.* at 213 n.32 (quoting SEC Rel. No. 34-3230 (May 21, 1942) and 8 SEC ANN. REP. 10 (1942)).

For a critical examination of the administrative history of rule 10b-5, see Cox, *Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of Its Impact upon the Scheme of the Federal Securities Laws*, 28 HASTINGS L.J. 569, 582 (1977). One commentator has concluded that "*Hochfelder's* establishment of a scienter requirement must be read to stand solely upon the interpretation of the statutory provision itself." *The Scienter Requirement*, *supra* note 16, at 424 n.39.

76. 425 U.S. at 213-14. The scope of rule 10b-5 cannot exceed the power delegated to the SEC through § 10(b). *Id.* "The rule-making power granted to an administrative agency charged with the administration of a federal statute is not the power to make law." *Id.* at 213.

Since the Court in *Hochfelder* found "the language and history of § 10(b) dispositive," it refused to examine policy considerations. *Id.* at 214 n.33.

77. *Id.* at 214.

III. *AARON V. SEC*: SCIENTER REQUIREMENT IN SEC INJUNCTIVE ACTIONS

A. *Factual Background of* Aaron

E.L. Aaron & Co. (Aaron & Co.) was a registered brokerage firm.[78] Peter Aaron had supervisory responsibility over Aaron & Co.'s registered representatives, including Norman Schreiber and Donald Jacobson. In connection with the solicitation of orders for the purchase of Lawn-A-Mat Corporation's (LAM) securities, Schreiber and Jacobson made the following representations: that LAM was in the process of developing a new type of small car, that LAM's stock was about to enjoy a substantial price increase, and that LAM was financially prospering. LAM, however, was not manufacturing, nor did it plan to manufacture, any cars. Furthermore, the company was losing money during the relevant period.[79] Peter Aaron both knew[80] and had reason to know[81] of Schreiber and Jacobson's misleading statements. Nevertheless, Peter Aaron failed to take affirmative steps to correct or stop the misstatements.[82]

The SEC filed a complaint in the District Court for the Southern District of New York seeking injunctive relief. The Commission charged that the defendant had violated and aided and abetted violations of section 17(a), section 10(b), and rule 10b-5. The trial court agreed and enjoined Peter Aaron from future violations of these antifraud provisions.[83] While noting that "negligence alone may suffice as a standard for liability in Commission enforcement proceedings," the district court found the defendant's intentional failure to terminate the misleading statements sufficient to establish scienter.[84]

The Court of Appeals for the Second Circuit affirmed the lower court's decision;[85] however, the Second Circuit ruled that negligence alone was sufficient to support injunctive actions under section 10(b) or section 17(a).[86] The Supreme Court reversed the judgment of the appellate court, finding that although scienter is not required in SEC injunctive proceedings based on section 17(a)(2)-(3), scienter is a prerequisite to a judicial grant of an SEC request for an injunction based upon either section 10(b) or section 17(a)(1).[87]

78. For a general discussion of the functions of a broker-dealer, see JAFFE, BROKER-DEALERS AND SECURITIES MARKETS (1977).

79. SEC v. E.L. Aaron & Co. [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043, at 91,682-83 (S.D.N.Y. May 5, 1977).

80. Peter Aaron was personally contacted by two representatives of LAM and told of the misrepresentations. *Id.* at 91,683.

81. The defendant also maintained due diligence files on LAM. These files contained no information regarding the manufacture of a car, but did indicate a deteriorating financial condition. *Id.*

82. *Id.*

83. *Id.* at 91,687.

84. *Id.* at 91,685.

85. SEC v. Aaron, 605 F.2d 612 (2d Cir. 1979).

86. *Id.* at 624.

87. Aaron v. SEC, 100 S. Ct. 1945, 1958 (1980).

B. Hochfelder *to* Aaron: *The Federal Courts Grapple with Scienter*

At the outset, it is important to note the distinction between the SEC's enforcement authority as compared with the private damages action at issue in *Hochfelder*. Unlike the judicially implied private remedy for violations of section 10(b), the Commission is expressly authorized to enjoin section 10(b) transgressions in section 21(d) of the 1934 Act. Similarly, for violations of section 17(a) of the 1933 Act, the SEC is expressly empowered under section 20(b) of the 1933 Act[88] to enjoin such acts. Both section 21(d) of the 1934 Act and 20(b) of the 1933 Act condition a court's power to issue an injunction upon "a proper showing" by the SEC that the defendant "is engaged or about to engage in any acts or practices which constitute or will constitute a violation" of the respective anti-fraud provisions. The text of these sections is devoid of any culpability standard.

Shortly after *Hochfelder* was decided, the Office of the General Counsel of the SEC issued a staff memorandum[89] that predicted that "[t]he *Hochfelder* decision clearly will have an impact upon pending and future Commission injunctive actions."[90] The first decision to assess such impact in the context of a section 10(b) violation was the Southern District of New York's opinion in *SEC v. Bausch & Lomb, Inc.*[91] Prior to *Bausch & Lomb*, the Second Circuit had consistently granted injunctions against defendants based merely on their unintentional misdeeds.[92] After reviewing *Hochfelder's* conclusion that the language and history of section 10(b) proscribed only intentional misconduct, the district court in *Bausch & Lomb* reasoned that the same must be true for all plaintiffs pursuing remedies under section 10(b)—regardless of the identity of the plaintiff or the nature of the remedy sought.[93] Since *Hochfelder* refused to consider policy considerations supporting a relaxed culpability standard,[94] the district court felt constrained to do likewise.[95]

The continued vitality of the Second Circuit's pre-*Bausch & Lomb* view

88. For the text of § 20(b) of the 1933 Act and § 21(d) of the 1934 Act, see note 6 *supra*.

89. Memorandum from The Office of the General Counsel of the Securities and Exchange Commission to Commission Staff Attorneys Regarding *Ernst & Ernst v. Hochfelder* (Apr. 26, 1976), *reprinted in* SEC. REG. & L. REP. (BNA) F-1 (May 26, 1976), [hereinafter cited as SEC Staff Memo].

90. *Id.* at F-1 (footnote omitted).

91. 420 F. Supp. 1226 (S.D.N.Y. 1976), *aff'd on other grounds*, 565 F.2d 8 (2d Cir. 1977). The Supreme Court's decision in *Hochfelder* was rendered during the course of the trial in *Bausch & Lomb*. On appeal to the Second Circuit, the Court of Appeals specifically refrained from deciding "whether scienter is a necessary predicate for injunctive relief." *Id.* at 14.

92. *See* note 21 *supra* and accompanying text.

93. The *Bausch & Lomb* court stated:

> Argument drawing upon the words of § 10(b) and the history, legislative and administrative, of both § 10(b) and Rule 10b-5 applies equally to private suits and actions brought by the Commission.
>
> . . . .
>
> A careful analysis of *Hochfelder* has convinced this Court that the distinction is no longer to be drawn and that the identical standard under § 10(b) and Rule 10b-5 must be applied whether the plaintiff is the SEC or a private litigant.

420 F. Supp. at 1241, 1243 n.4.

94. 425 U.S. at 214 n.33.

95. 420 F. Supp. at 1241. The district court noted that "[o]nly policy considerations . . . could support" a relaxation of the scienter requirement. *Id.*

of the culpability standard in injunctive proceedings was suggested in *Arthur Lipper Corp. v. SEC*.[96] The court reviewed an SEC order revoking a broker-dealer's registration because of violations of section 10(b).[97] Judge Friendly likened a private damages action to an SEC administrative disciplinary proceeding: both remedies visit "serious consequences on past conduct," and proof of scienter is, therefore, warranted in both actions. This is in contrast, the court urged, to SEC injunctive suits whose design "is solely to prevent threatened future harm."[98] In view of this distinction as to the nature of the remedies, *Arthur Lipper* intimated that *Hochfelder*'s scienter rule did not apply to Commission injunctive proceedings.[99]

The Second Circuit further questioned *Bausch & Lomb's* holding in *SEC v. Universal Major Industries Corp.*[100] The Commission in this case sought an injunction against an attorney who allegedly aided and abetted his client in selling unregistered securities in violation of section 5 of the 1933 Act.[101] The defendant argued that, pursuant to *Hochfelder*, intent to deceive must be proved. The court in *Universal Major* granted the injunction, noting, by way of dictum, that "*Hochfelder*, which was a private suit for damages, does not undermine our prior holdings" that scienter is not required in SEC injunctive proceedings.[102]

Notwithstanding the Second Circuit's aversion to the *Bausch & Lomb* rationale, the Fifth Circuit required scienter in an SEC injunctive suit in *SEC v. Blatt*.[103] The Fifth Circuit essentially echoed the analysis of *Bausch & Lomb*[104]—with one significant wrinkle. The *Hochfelder* Court had read the language and history of section 10(b) to require scienter; however, *Hochfelder* involved a remedy not rooted in the language of the statute—it was concerned with a judicially created private cause of action.[105] The *Blatt* court reasoned that since Congress had *expressly* empowered the SEC to seek injunctive relief for section 10(b) violations through section 21(d) of the 1934

96. 547 F.2d 171 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1977).

97. *Id.* at 173. The statutory culpability standard in SEC administrative enforcement actions is "willfully." Section 15(b)(4) of the 1934 Act, 15 U.S.C. § 78o(b)(5) (1976). The Tenth Circuit in Mawod v. SEC, 591 F.2d 588, 596 (10th Cir. 1979), considered the reach of *Hochfelder* in the context of SEC sanctions against broker-dealers. *See generally Securities, Sixth Annual Tenth Circuit Survey*, 57 DEN. L.J. 319, 323-28 (1980).

When considering broker-dealer suspensions and revocations, courts have traditionally viewed this remedy as more prophylactic than punitive. Accordingly, the courts have relaxed the § 15(b)(4) willfulness requirement. *See generally The Scienter Requirement*, *supra* note 16, at 433 n.79.

98. 547 F.2d at 180 n.6.

99. *Id.*

100. 546 F.2d 1044 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977).

101. 15 U.S.C. § 77e (1976). It is noteworthy that the Commission did not allege a § 10(b) violation, especially since the defendant's conduct appeared to be actionable under rule 10b-5. *See, e.g.*, SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); *see generally* GA. L. REV., *supra* note 15, at 886 n.35.

102. 546 F.2d at 1047. The Second Circuit did not rest its holding on the "negligence-scienter argument." Rather, *Universal Major* found that the defendant acted with scienter (*i.e.*, with knowledge or reckless disregard for the truth), obviating the good faith defense.

103. 583 F.2d 1325 (5th Cir. 1978).

104. *Id.* at 1332-34.

105. *See* note 64 *supra*.

Act,[106] arguably "the scienter requirement implicit in the statute [section 10(b)] must have been intended for SEC proceedings."[107] Therefore, the *Blatt* court drew "a stronger inference that Congress intended to require scienter in SEC actions than in private damages suits."[108]

C. *The Supreme Court Decides That Scienter Is a Necessary Element of a Section 10(b) Violation*

1. The Court Relies on the *Hochfelder* Rationale

Delivering the opinion of the Court in *Aaron*, Justice Stewart ruled that the *Hochfelder* rationale "ineluctably leads to the conclusion that scienter is an element of a violation of section 10(b) and rule 10b-5, *regardless of the identity of the plaintiff or the nature of the relief sought.*"[109] Justice Stewart reasoned that *Hochfelder's* reading of section 10(b)'s language and legislative history controlled, regardless of whether the plaintiff was a private party suing for damages or the Commission seeking injunctive relief.[110] This view is consistent with the district court's decision in *Bausch & Lomb* and with the Fifth Circuit's opinion in *Blatt*. *Aaron* also embraced the novel reasoning expressed by the Fifth Circuit in *Blatt*.[111] Since *Hochfelder* involved a judicially implied action not within Congress' contemplation, it would be "quite anomalous" if *Hochfelder's* interpretation of section 10(b) would not similarly govern the express remedy Congress created for the SEC.[112]

Justice Blackmun, dissenting in *Hochfelder*, had argued that the culpability standard "should not depend upon the plaintiff's identity."[113] The dissent could "see no real distinction" between private damages actions and SEC enforcement proceedings, both predicated on section 10(b).[114] The *Aaron* decision at least settles Justice Blackmun's concern for judicial inconsistency.

In its treatment of *Aaron*, the Second Circuit had looked to section 21(d)

106. The text of § 21(d) of the 1934 Act is contained in note 6 *supra*.

107. 583 F.2d at 1333 n.21.

108. *Id.*

109. 100 S. Ct. at 1952 (emphasis added).

110. *Id. Aaron* noted that the third leg of *Hochfelder's* analysis—the structure of civil liability provisions in the 1933 and 1934 Acts—would not be relevant in a statutory injunctive action. *Id.* at 1952-53 n.9. *Hochfelder* did not rest its decision solely on this third factor. Rather, Justice Powell urged that the text of § 10(b), standing alone, was sufficient to support a scienter standard. 425 U.S. at 201.

111. *See* notes 103-08 *supra* and accompanying text.

112. 100 S. Ct. at 1952-53.

113. 425 U.S. at 217 (1976) (Blackmun, J., dissenting). The Commission also advanced the position that the plaintiff's identity was irrelevant to imposing a scienter standard. Brief for SEC as Amicus Curiae at 8, 16-17, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

114. 425 U.S. at 217-18. Justice Blackmun also dissented in *Aaron*. His assertions in *Hochfelder* seem somewhat incongruous with his position in *Aaron* that the SEC—and not a private party—should be granted an injunction under § 10(b) when the defendant is merely negligent. In fairness to Justice Blackmun, however, it appears that he is consistently advocating the view that *Hochfelder* reached the wrong conclusion, and both private damages actions and SEC injunctive proceedings should be successful if the plaintiff can show mere unintentional conduct.

of the 1934 Act[115] to determine if scienter was required in SEC actions.[116] The Second Circuit noted that during enactment of the Securities Acts Amendments of 1975, Congress expressed an intent to exempt the Commission from the scienter requirement.[117] The Senate Report provided: "In particular, issues related to matters of damages, such as scienter, causation and the extent of damages are elements *not* required to be demonstrated in a Commission injunctive action."[118] The Second Circuit concluded that the legislative intent of section 21(d) indicated that scienter was not contemplated for SEC injunctive suits.[119]

Justice Stewart rejected, without discussion, the notion that the legislative history of section 21(d) suggests a relaxation of the scienter requirement in SEC actions.[120] Moreover, a closer examination of the language of section 21(d) belies the Second Circuit's position. Section 21(d) provides that the SEC is authorized to seek injunctive relief only when it appears that the defendant "is engaged or is about to engage in acts or practices *constituting a violation* of [section 10(b)]" and that "upon a proper showing" a district court shall grant the injunction.[121] As Justice Stewart explained, at minimum "a proper showing" must include proof that the defendant is presently engaged in, or is about to engage in, a substantive violation of section 10(b).[122] Since the Court in *Hochfelder* read the language and history of section 10(b) as requiring a showing of scienter before a court can conclude that section 10(b) has been violated, an injunction likewise is not authorized under section 21(d) until scienter has been proven.[123]

2. The *Aaron* Court Distinguishes a Prior Decision

The Commission urged the Court in *Aaron* to look to *SEC v. Capital Gains Research Bureau, Inc.*,[124] for precedential guidance.[125] Justice Stewart refused

115. Section 21(d) is the explicit statutory provision in the 1934 Act which empowers the Commission to seek an injunction. The text of § 21(d) is found at note 6 *supra*.

116. SEC v. Aaron, 605 F.2d 612, 621-22 (2d Cir. 1979).

117. *Id.* at 622.

118. S. REP. NO. 75, 94th Cong., 1st Sess. 76 (1975), *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 179, 254 (citations omitted) (emphasis in original).

119. 605 F.2d at 622.

120. The Supreme Court did not address the Senate Report referred to in the court of appeals decision. Justice Stewart simply declared that "there is nothing in the legislative history of [§ 21(d)] to suggest a contrary intent." 100 S. Ct. at 1958.

121. 15 U.S.C. § 78u(d) (1976) (emphasis added).

122. 100 S. Ct. at 1957-58. The *Aaron* Court said:

> The elements of "a proper showing" thus include, at a minimum, proof that a person is engaged in or is about to engage in a substantive violation of either one of the Acts [1933 or 1934 Acts] . . . . Accordingly, when scienter is an element of the substantive violation sought to be enjoined, it must be proven before an injunction may issue.

Id.

123. In response, the Second Circuit and the Commission would probably argue that, under § 21(d), it is not necessary to first prove a *past* violation of § 10(b) to obtain an injunction to prevent conduct that will violate the act. *See generally* GA. L. REV., *supra* note 15, at 890-91; Comment, *SEC Injunctive Suits*, *supra* note 16, at 1023. As a practical matter, however, courts generally are reluctant to enjoin future violations without a showing that the defendant has already acted with scienter. This is apparent even in those circuits that concluded § 10(b) would be violated if the defendant engaged in mere negligent behavior. *See* Lowenfels, *supra* note 16, at 790; *New Light on an Old Debate*, *supra* note 16, at 784.

124. 375 U.S. 180 (1963).

this advice, concluding "that the controlling precedent here is not *Capital Gains* but rather *Hochfelder*."[126]

In *Capital Gains*, the Court decided whether section 206(2) of the Investment Advisers Act of 1940[127] (IAA) required the Commission to prove scienter when it sought injunctive relief.[128] The Court ruled that a showing of intent to defraud was not required.[129] The decision rested upon the legislative intent apparent in enacting the IAA, the elements of common law fraud, and the appropriate scienter requirement when a fiduciary duty is present.[130]

Justice Goldberg, speaking for the *Capital Gains* Court, focused chiefly on the IAA's purpose: to expose or eliminate all of an investment advisor's conflicts of interest in connection with his fiduciary position.[131] The Supreme Court held, accordingly, that "[i]t would defeat the manifest purpose" of the IAA if the SEC was required to prove the advisor's state of mind.[132] Second, *Capital Gains* drew a distinction between actions at law and actions in equity.[133] Courts traditionally have relaxed the culpability requirement in light of the nature of the action (at law or in equity), the character of the transaction,[134] and the special relationships of the parties.[135] Additionally, the Court observed that the elements of a fraud action should be tempered when a fiduciary relationship is part of the factual setting.[136]

The *Aaron* Court distinguished *Capital Gains* on three grounds: the legislative history, the statutory language, and the special fiduciary relationship.[137] The majority in *Capital Gains* had looked to the congressional intent surrounding the IAA to support its conclusion that scienter is not required in actions under section 206(2). In contrast, the Court in *Hochfelder* inferred, from the legislative history of section 10(b), a congressional reluctance to expand the ambit of liability to include unintentional behavior.[138] Justice Stewart in *Aaron* indicated that the phrase "any . . . course of business which operates as a fraud or deceit," in section 206(2) is concerned with the

125. Aaron v. SEC, 100 S. Ct. 1945, 1953 (1980).

126. *Id.* at 1954.

127. 15 U.S.C. § 80b-6 (1976). For the text of § 206(2), *see* note 201 *infra*.

128. 375 U.S. at 181-82.

129. *Id.*

130. *See generally* Berner & Franklin, *supra* note 16, at 781-85; *The Scienter Requirement*, *supra* note 16, at 435-37; Comment, *SEC Injunctive Suits*, *supra* note 16, at 1021-23.

131. 375 U.S. at 191-92.

132. *Id.* at 192.

133. *Id.* at 192-95.

134. *Id.* at 194. The Court noted:

> There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

Id. (footnote omitted).

135. Justice Goldberg stressed that in a fiduciary relationship, it was not necessary at common law to establish all the elements of an arm's-length transaction. *Id.*

136. *Id.*

137. 100 S. Ct. at 1954-55.

138. *Id.* at 1954. *See generally* Note, *The Investment Advisers Act and the Supreme Court's Interpretation of its Antifraud Provisions*, 37 S. CAL. L. REV. 359, 366 (1964).

effect of the transaction—not the state of mind of the actor.[139] Section 10(b), however, contains the terms "manipulative" and "contrivance" that in *Hochfelder* were held to clearly refer to a state-of-mind requirement. The Court noted that section 206(2) governs a special fiduciary relationship, that of an investment advisor to his client. Section 10(b), in contrast, applies equally to fiduciary relationships and arm's-length transactions.[140] An additional factor served to circumscribe *Capital Gains's* precedential value to the Court in *Aaron*: Justice Goldberg had specifically found that the defendant's conduct was purposeful; the case did not involve unintentional misconduct.[141] In addition, Justice Goldberg cited authority for the proposition that at common law, fraud had a broader sweep in equity than at law.[142] Indeed, equitable relief traditionally was granted without a showing of the defendant's state of mind.[143] The relief granted was usually rescission, reformation of contract, or imposition of an equitable lien.[144] An injunction was viewed as a more drastic remedy.[145] The Court in *Capital Gains*, however, reasoned that an injunction was a "mild prophylactic" and thus the elements of common law fraud ought to be moderated.[146] Lower federal courts subsequently have recognized that an injunction can be a punitive sanction.[147]

D. *Post*-Hochfelder *Cases Predicated on Section 17(a) Violations*

The SEC Staff Memo that followed in the wake of *Hochfelder* correctly anticipated an avenue of escape from the scienter burden involved in SEC attempts to enjoin conduct violative of section 10(b). The memorandum urged the staff to include allegations of violations of section 17(a) of the 1933 Act in their complaints. It was asserted that even if the court should read *Hochfelder* "in a manner hostile to the Commission," the court still would have "an alternative basis upon which to find a violation and to issue an injunction."[148]

Less than two months after *Bausch & Lomb* was decided, the First Circuit, in *SEC v. World Radio Mission, Inc.*,[149] was faced, not surprisingly, with a

139. 100 S. Ct. at 1954. Section 206(2) of the IAA is essentially identical to rule 10b-5(c) and Section 17(a)(3) of the 1933 Act. *Aaron* interpreted the similar wording of these sections in a consistent fashion, since the high Court read section 17(a)(3) not to include a scienter requirement. *See* notes 224-29 *infra* and accompanying text.

140. 100 S. Ct. at 1954.

141. 375 U.S. at 192 n.39. The conduct of Peter Aaron, similarly, involved an intent to defraud.

142. *Id.* at 193.

143. W. PROSSER, HANDBOOK OF THE LAW OF TORTS 687-88 (4th ed. 1971).

144. *Id.* at 687.

145. *See generally* Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1292-96 (1976).

146. 375 U.S. at 193. Chief Justice Burger, in his *Aaron* concurrence, urged that "[a]n injunction is a drastic remedy, not a mild prophylactic." 100 S. Ct. at 1959.

147. *E.g.*, SEC v. Caterinicchia, 613 F.2d 102, 105 (5th Cir. 1980) (characterizing statutory injunctive relief as an extraordinary measure); SEC v. Cenco Inc., 436 F. Supp. 193, 198 (N.D. Ill. 1977) ("We agree that no injunction should be lightly issued, for the ramifications are very serious.") *See* notes 281-300 *infra* and accompanying text.

148. SEC Staff Memo, *supra* note 89, at F-3.

149. 544 F.2d 535 (1st Cir. 1976).

Commission enforcement action founded both on section 17(a) and section 10(b).[150] The First Circuit, limiting *Hochfelder*'s good faith defense to private actions for past anti-fraud violations,[151] concluded that a defendant's state of mind is irrelevant to an injunction determination.[152] The function of an injunction, the court explained, was to "protect the public against conduct, not to punish a state of mind."[153] *World Radio Mission* did not concern itself with the sweep of *Hochfelder*; rather, the First Circuit rested its decision solely on section 17(a) and ignored the section 10(b) claim.[154] The defendant argued that since section 17(a) contains language virtually identical to rule 10b-5(2),[155] and since *Hochfelder* read section 10(b) as requiring scienter, section 17(a) should be similarly interpreted.[156] The First Circuit recognized the fallacy in this argument.[157] The Supreme Court in *Hochfelder* acknowledged that the language of rule 10b-5, of its own force, may be read to include negligent behavior.[158] Justice Powell, however, held that such a reading of the rule would exceed the statutory rulemaking authority of the Commission, since the Court interpreted section 10(b) to require a showing of scienter.[159] If anything, *Hochfelder's* narrow interpretation of rule 10b-5 reinforces *World Radio Mission's* view of section 17(a).[160] Although both Section 17(a) and section 10(b) are commonly referred to as the antifraud provisions of the securities laws, section 17(a) has its own language and legislative history,[161] which should be accorded independent vitality and not swallowed by the *Hochfelder* view of section 10(b).[162]

In a well-reasoned opinion, the Second Circuit, in *SEC v. Coven*,[163] upheld an SEC injunction based on section 17(a) violations in the absence of an intent to defraud. Following the First Circuit's lead in *World Radio Mission*, Judge Mansfield, for the *Coven* court, focused solely on section 17(a) and explicitly refrained from deciding whether scienter was required in SEC actions under section 10(b).[164] Judge Mansfield's examination of section 17(a) virtually paralleled the *Hochfelder* treatment of section 10(b). Specifically,

150. *Id.* at 537.
151. *Id.* at 540.
152. *Id.*
153. *Id.* at 541.
154. *World Radio Mission* noted: "Thus, strictly speaking, since this action is founded on both section 17(a) and Rule 10b-5, we need not decide what result would obtain in an SEC injunction action based solely on section 10(b) and Rule 10b-5 . . . ." *Id.* at 541 n.10.
155. For the language of rule 10b-5 and section 17(a) of the 1933 Act, see, respectively, notes 20 and 31 *supra*. Indeed, the language of rule 10b-5 was borrowed by the SEC from § 17(a). The Commission sought to make § 17(a)'s proscriptions applicable to buyers as well as sellers. 3 L. LOSS, SECURITIES REGULATION 1426-27 (2d ed. 1961).
156. 544 F.2d at 541 n.10.
157. *Id.*
158. *See* notes 73-77 *supra* and accompanying text.
159. 425 U.S. at 212-14.
160. *E.g.*, SEC v. Coven, 581 F.2d 1020, 1027 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979). *See generally* Comment, *SEC Injunctive Suits*, *supra* note 16, at 1021 n.24; Note, *Scienter and SEC Injunctive Actions Under Securities Act 17(a)*, 63 IOWA L. REV. 1248, 1255-56 (1978) [hereinafter cited as Note, *Securities Act 17(a)*].
161. *See* notes 174-80 *infra* and accompanying text.
162. For an argument that scienter should be required for actions predicated on § 17(a), see Berner & Franklin, *supra* note 16, at 796 n.221.
163. 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979).
164. *Id.* at 1026 n.10.

Coven reviewed the language of section 17(a), the legislative history, and the structure of the remedies of the securities acts.

The *Coven* court viewed section 17(a)(2)'s language as giving no indication of a good faith defense that would imply a culpability standard requiring scienter.[165] In addition, the Second Circuit read the clause "operate as a fraud or deceit" of subsection (3) as focusing attention on the *effect* of the misrepresentation on the investing public, not on the actor's state of mind.[166] Some courts[167] and commentators[168] have maintained that the use of the terms "fraud" and "deceit" in subsection (3) inherently entails an intent requirement. The *Coven* court disagreed.[169] Judge Mansfield viewed the legislative thrust of section 17(a) as expanding common law fraud to allow actions in the absence of scienter.[170] Indeed, frustration with the ineffectiveness of a tort action in fraud was one of the considerations in drafting the 1933 Act.[171] Moreover, Justice Powell in *Hochfelder* noted that "[v]iewed in isolation the language of [rule 10b-5(2)] and arguably that of [rule 10b-5(3)], could be read as proscribing . . . any course of conduct . . . whether the wrongdoing was intentional or not."[172]

After canvassing congressional history regarding the appropriate culpability standard for section 17(a), the Second Circuit concluded that its "reading of the language of section 17(a) is in accord with its [section 17(a)'s] legislative history."[173] Without recounting the details of the legislative his-

165. *Id.* at 1026.

Most commentators agree that § 17(a)(2) has no scienter requirement. *E.g.*, 6 L. LOSS, SECURITIES REGULATION 3552-53 (2d ed. Supp. 1969). *Contra*, Meisenholder, *infra* note 168, at 41. Section 17(a)(2) contains no reference to fraud, deceit, or manipulation. It prohibits the procurement of property through a material misrepresentation. Of course, one can negligently or intentionally mislead another. This statutory subsection looks to the end result and appears indifferent to the actor's state of mind.

166. *Id.* at 1026 n.11.

167. *E.g.*, Sanders v. John Nuveen & Co., Inc., 554 F.2d 790 (7th Cir. 1977); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 770 (D. Colo. 1964). *Sanders* argued that "even if such a private cause of action does exist under § 17(a), it would require proof of scienter. Proof of scienter is unquestionably required as to subsections (1) and (3) which specifically refer to fraud. Subsection (2), on the other hand, does not expressly refer to fraud." 554 F.2d at 795.

168. *E.g.*, 3 A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 8.4(330), at 204.23 (1977); 3 L. LOSS, SECURITIES REGULATION 1440-41 (2d ed. 1961). *See generally* Meisenholder, *Scienter and Reliance as Elements in Buyer's Suit Against Sellers Under Rule 10b-5*, 4 CORP. PRAC. COMMENTATOR 1963, at 27, 44-47.

169. 581 F.2d at 1026 n.11.

170. *Id.*

171. *See, e.g.*, S. REP. NO. 47, 73d Cong., 1st Sess. 2 (1933); H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-3 (1933); 77 CONG. REC. 2983 (1933) (remarks of the sponsor of the Senate bill).

Other commentators have argued for interpreting subsection (3) to include within its proscription negligent conduct, but for different reasons. One author, for example, emphasized subsection (3)'s focus upon the effect of the defendant's conduct rather than his mental culpability. *The Scienter Requirement*, *supra* note 16, at 431 n.72. Still another commentator engaged in a different analysis. *See generally* Note, *Securities Act 17(a)*, *supra* note 160, at 1253-54. The author begins with the premise that "a statute should be construed in a manner that would give effect to all its provisions." *Id.* at 1253. Accordingly, the additional language of subsection (3) must make it somewhat unique from subsection (1). Given that subsection (1) proscribes only intentional conduct, the commentators conclude that subsection (3)'s ambit should include actions "done without the intent or knowledge of the defendant." *Id.* at 1254.

172. 425 U.S. at 212. Of course, the text of rule 10b-5(3) is virtually identical to subsection (3) of section 17(a).

173. 581 F.2d at 1027.

tory,[174] the essence of it is as follows: The House and Senate passed different versions of the 1933 Act. The House bill, H.R. 5480,[175] did not include a willfulness requirement, but the Senate bill, S. 875,[176] included the phrases "willfully to employ" and "with intent to defraud."[177] After the House refused to agree to the Senate's bill, a Conference Committee was appointed.[178] Section 17(a) of the Committee's bill was patterned after H.R. 5480,[179] thus deleting the Senate's state-of-mind language. The Second Circuit in *Coven* reasoned that since the Conference Committee "opted for liability without willfulness, intent to defraud, or the like," the conferees could not have intended to impose a showing of scienter under section 17(a).[180]

Finally, in *Coven*, the Second Circuit recognized a concern shared by the Supreme Court in *Hochfelder*: A reading of section 10(b) that would permit private suits based upon unintentional conduct would undermine those sections of the 1933 Act explicitly based on a negligence standard. This is because unlike section 10(b), sections 11, 12(2) and 15 of the 1933 Act contain procedural limitations that impinge upon a plaintiff's ability to bring suit.[181] Even assuming the existence of a judicially implied private right of action under section 17(a),[182] the Second Circuit noted that *Hochfelder*'s procedural limitation concern could not properly act to limit the ambit of section 17(a) when the SEC is the plaintiff.[183] In the face of section 20(b) of the 1933 Act, which explicitly authorizes the injunctive action for violation of, *inter alia*, section 17(a), Congress clearly recognized the potential liability to defendants involved in Commission enforcement suits.

Shortly after *Coven*, the Fourth Circuit, in *SEC v. American Realty Trust*,[184] decided that "in an action for an injunction against future violations brought by the Commission, proof of scienter is unnecessary."[185] Fol-

174. For a thorough examination of the legislative history surrounding section 17(a), see Note, *Securities Act 17(a)*, *supra* note 160, at 1257-59. For the history of the 1933 Act in general, see *The Scienter Requirement*, *supra* note 16, at 429-35, and Landis, *The Legislative History Of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 45 (1959).

175. H.R. REP. NO. 85, 73d Cong., 1st Sess. (1933). During the House hearings, H.R. 5480 was substituted for H.R. 4314.

176. S. REP. NO. 47, 73d Cong., 1st Sess. (1933), *reprinted in Hearings on S. 875 Before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess. 1-8 (1933).

177. The Senate bill, after amendment, included the following provision:

> Sec. 13. It shall be unlawful for any person, firm, corporation, or other entity, directly or indirectly, in any interstate sale . . . or distribution of any securities *willfully* to employ any device, scheme, or artifice . . . *with the intent to defraud* or to obtain money or property by means of any false pretense . . . or to engage in any transaction . . . relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser . . . . S. 875, 73d Cong., 1st Sess. (1933) (emphasis added).

178. 77 CONG. REC. 3000, 3085 (1933).

179. H.R. CON. REP. NO. 152, 73d Cong., 1st Sess. 12, 27 (1933).

180. 581 F.2d at 1027.

181. *See* notes 65-72 *supra* and accompanying text.

182. *See* note 64 *supra*.

183. 581 F.2d at 1027.

The Ninth Circuit, in SEC v. Blazon Corp., 609 F.2d 960 (9th Cir. 1979), relied almost totally on *Coven's* rationale and held that "[a] showing of fraudulent intent is not required in an action for an injunction brought by the Commission under § 17(a)." *Id.* at 965.

184. 586 F.2d 1001 (4th Cir. 1978).

185. *Id.* at 1002.

lowing the blueprint established by the First and Second Circuits, *American Realty* confined its attention to section 17(a),[186] examining the language of subsection (2) of section 17(a)[187] and its legislative history.[188] In addition, *American Realty* distinguished the decision of the Seventh Circuit in *Sanders v. John Nuveen & Co., Inc.*,[189] which was based upon a private action for damages. The Fourth Circuit commented that pursuant to "the whole legislative scheme," a court should not imply a private right of action under section 17(a) without simultaneously "including a requirement of fraud or willfulness."[190] In dictum,[191] the *American Realty* opinion clearly indicated that it probably would not create such a private action, and, therefore, the language of section 17(a)(2) could be accorded its commonly accepted meaning. The *American Realty* court went on to conclude that those considerations were immaterial when the Commission pursued its statutorily created injunction.[192]

The circuit opinion most relevant to the *Aaron* decision is that of *Steadman v. SEC*.[193] The Court in *Aaron*[194] ultimately embraced the Fifth Circuit's reasoning in *Steadman*. With this decision, the Fifth Circuit came full circle. The Fifth Circuit had previously held in *Blatt* that the Commission must prove scienter in an injunctive action under section 10(b).[195] In *Steadman*, the court clarified its position on scienter when the Commission, in an administrative proceeding under section 15(b) of the 1934 Act,[196] sought to discipline an investment advisor based on alleged violations of section 17(a) of the 1933 Act. For the most part, the court followed existing post-*Hochfelder* precedent,[197] with special emphasis on *Coven*;[198] *Steadmen* offered some unique contributions, however.

The petitioner in *Steadman* contended that *Coven* was distinguishable—an injunctive action as opposed to an administrative disciplinary proceeding. Judge Tjoflat, for the court, refused to interpret the language of 17(a) one

186. "And because of the Supreme Court's holding in [*Hochfelder*], that scienter must be proven in a private action under § 10(b) and Rule 10b-5, we will confine our attention to § 17 of the Securities Act of 1933." *Id.* (footnote omitted).

187. Contrary to *Coven*, the Fourth Circuit suggested it would have read § 17(a)(3), which includes the language "operates or would operate as a fraud," as connoting a scienter requirement. *Id.* at 1006.

188. *American Realty* found itself "in complete agreement" with *Coven's* reading of § 17(a)'s legislative history. *Id.*

189. 554 F.2d 790 (7th Cir. 1977). *Sanders* interpreted subsection (2) of § 17(a) as mandating an intent requirement: "Even if we assume that an implied cause of action does exist under § 17(a), for the same reasons expressed by the Court in *Hochfelder* we do not believe that such cause of action can be premised upon negligent wrongdoing." *Id.* at 796.

190. 586 F.2d at 1006-07.

191. The Fourth Circuit was faced with an SEC enforcement action, not a private damages action. *Id.* at 1007.

192. *Id.* at 1006-07.

193. 603 F.2d 1126 (5th Cir. 1979).

194. For a discussion of *Aaron*, *see* text accompanying notes 207-29 *infra*.

195. *See* notes 103-08 *supra* and accompanying text.

196. A review of SEC administrative disciplinary proceedings is contained in note 97 *supra*.

197. Pursuant to *World Radio Mission*, the Fifth Circuit was careful to concentrate on § 17(a), and not § 10(b). Furthermore, *Steadman* discussed, as did *Coven* and *American Realty*, the language and legislative history of § 17(a).

198. *Steadman* specifically adopted *Coven's* interpretation of the legislative history of § 17(a)(3). 603 F.2d at 1132-33.

way when the remedy was an injunction and yet another way when a stronger sanction was sought.[199] In sum, the court ruled that the reach of section 17(a) turned not on the character of the relief sought but rather it turned on the language of the statute.[200]

Steadman, like *Coven*, construed subsection (3) of section 17(a) as imposing liability for mere negligence. To support this reading of subsection (3), Judge Tjoflat cited the Supreme Court's construction of identical language in section 206(2) of the IAA[201] in *Capital Gains*.[202] In *Capital Gains*, the Supreme Court rejected the position that the terms "fraud" and "deceit" required proof of scienter.[203] The Supreme Court reasoned that "Congress intended the [IAA] to be construed like other securities legislation . . . not technically and restrictively, but flexibly to effectuate its remedial purposes."[204]

Perhaps the most significant discussion in *Steadman* was its interpretation of the clause "to employ any device, scheme, or artifice to defraud" contained in section 17(a)(1).[205] The court concluded that the phrases "device to defraud", "scheme to defraud", and "artifice to defraud", when viewed separately, gave rise to a strong implication that this subsection required intentional misconduct.[206]

E. *The Supreme Court Decided Against A Uniform Section 17(a) Culpability Requirement*

The *Aaron* Court prefaced its analysis of the language and legislative history of section 17(a) of the 1933 Act with a discussion of some guidelines for courts construing federal securities statutes.[207] Justice Stewart faced two lines of precedent. *Capital Gains* stressed that securities legislation should be interpreted "not technically and restrictively, but flexibly to effectuate its remedial purposes."[208] *SEC v. Sloan*,[209] however, emphasized that waving the "remedial purposes" banner will not justify reading securities laws "more broadly than [their] language and the statutory scheme reasonably per-

199. 603 F.2d at 1133.

200. A similar line of reasoning was followed in *Blatt* regarding a good faith defense to a § 10(b) violation. The court held that § 10(b) afforded the defendant a good faith defense whether the relief sought was money damages or an injunction. *See* notes 103-08 *supra* and accompanying text.

201. 15 U.S.C. § 80b-6(2) (1976). This section provides that:

> It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> . . . .
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

202. 375 U.S. 180 (1963).

203. *Id.* at 195.

204. *Id. See also* Note, *Securities Act 17(a)*, *supra* note 160, at 1257.

205. 603 F.2d at 1133.

206. *Steadman* also noted that *Hochfelder* found the terms "device" and "employ" of § 10(b) as suggestive of intentional misconduct. *Id.*

207. 100 S. Ct. at 1955.

208. 375 U.S. at 195.

209. 436 U.S. 103 (1978).

mit."[210] *Aaron* concluded that if the statutory text of the securities laws "is sufficiently clear in its context and not at odds with the legislative history," a court should look no further.[211] Specifically, Justice Stewart admonished courts not to examine policy considerations when reading such statutes.[212]

1. Subsection (1) of Section 17(a)

The Court in *Aaron* essentially adopted the position of *Steadman*. The Supreme Court found that the language of subsection (1) of section 17(a) "strongly suggests" some scienter requirement.[213] Justice Stewart read the terms "device", "scheme", and "artifice" as connoting intentional misconduct.

Justice Stewart reviewed the legislative history surrounding section 17(a). As discussed in *Coven*, the Senate version of section 17(a) read "willfully to employ any device, scheme, or artifice."[214] The House bill, however, omitted the term "willfully."[215] Since the Conference Committee patterned its bill after the House bill,[216] the SEC urged that, by deleting this state-of-mind requirement, Congress intended to reject a scienter standard.[217] The Court's decision, however, drew the inference (since the Conference Report was silent as to the scienter question) that Congress believed that adding the term "willfully" would be "simply redundant."[218] Therefore, the Court in *Aaron* could find no "conflict between the reasonably plain meaning and legislative history."[219]

Justice Blackmun, in his dissent in *Aaron*,[220] disputed the Court's reading of section 17(a)(1). Looking to *Capital Gains* as the proper approach to reading securities statutes, Justice Blackmun viewed the phrase "device, scheme, or artifice to defraud" of subsection (1) as covering "a range of be-

210. *Id.* at 116.

211. 100 S. Ct. at 1955. A court still is vested with considerable discretion. For example, when are the securities provisions "sufficiently clear" or "not at odds with" Congress' intent?

212. The Court cited *Hochfelder*. A court can still consider policy factors if the language is not sufficiently clear or at odds with the statute's history. Moreover, this bar from examining policy applies only when a court is construing a specific provision. The admonition does not apply to a court considering whether to issue an injunction. *See* notes 255-59 *infra* and accompanying text.

213. 100 S. Ct. at 1955.

214. S. 875, 73d Cong., 1st Sess. (1933).

215. H.R. 5480, 73d Cong., 1st Sess. (1933). The House also rejected a proposal to modify the clause "to employ any device, scheme, or artifice," and to add "with intent to defraud." *Federal Securities Act: Hearings on H.R. 4314 Before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 146 (1933).

216. H.R. CON. REP. NO. 152, 73d Cong., 1st Sess., 12, 27 (1933).

217. 100 S. Ct. at 1957.

218. *Id.* Justice Blackmun disputed this inference. The Justice contended that the Conference Report noted that several "clarifying changes" of the Senate bill were intended "to remove uncertainties" regarding SEC powers. H.R. CON. REP. NO. 152, 73d Cong., 1st Sess. 24 (1933). Justice Blackmun concluded that "retention of the Senate's explicit state-of-mind language undoubtedly would have added clarity to Congressional intent." 100 S. Ct. at 1961 n.1.

219. 100 S. Ct. at 1957. Justice Stewart did acknowledge, however, that the history of § 17(a) was "ambiguous." *Id.*

220. Justice Blackmun, with whom Brennan and Marshall joined, concurred in part and dissented in part. Chief Justice Burger wrote a separate concurrence.

havior including but not limited to intentional misconduct."[221] The dissent then proceeded to interpret "device to defraud" as reaching negligent acts as well.[222] Justice Blackmun, who also dissented in *Hochfelder*, apparently did not feel compelled to follow *Hochfelder*'s reading of "device": "[a term] that make[s] unmistakable a congressional intent to proscribe a type of conduct quite different from negligence."[223]

2. Subsections (2) and (3) of Section 17(a)

Aaron's view of subsections (2) and (3) paralleled the decisions of *Coven*, *American Realty*, and *Steadman*. Justice Stewart easily concluded that section 17(a)(2) "is devoid of any suggestion whatsoever of a scienter requirement."[224] *Aaron* cited *Hochfelder*'s interpretation of the similar language of rule 10b-5(2) as supporting its reading of section 17(a)(2).[225]

Similarly, Justice Stewart held that subsection (3) did not require the SEC to establish scienter.[226] After noting that section 17(a)(3) focuses on the effect of one's conduct—not on the actor's state of mind—the Supreme Court looked for further support to the argument advanced in *Steadman*.[227] That is, since the Supreme Court in *Capital Gains* concluded that section 206(2) of the IAA,[228] which contains essentially the same language as section 17(a)(3), did not require a showing of intentional misdeeds, no different result could occur under section 17(a)(3). Finally, Justice Stewart examined the legislative history of both section 17(a)(2) and 17(a)(3), and concluded that the history was "entirely consistent with the plain meaning of section 17(a)."[229]

IV. IMPLICATIONS OF *AARON*

A. *Only Seller's Negligent Misrepresentations Are Actionable*

Since the language of section 17(a) of the 1933 Act applies only to those who sell securities,[230] rule 10b-5 was promulgated to cover both purchasers and sellers.[231] In the wake of *Aaron*, however, courts will only be allowed to

221. 100 S. Ct. at 1961. Justice Blackmun noted that the terms are couched in the disjunctive and thus "each should be given its separate meaning." *Id.*

222. *Id.* Justice Blackmun relied principally on three grounds to support his reading of the term "device": (1) the legislative history used "device" as a synonym for "practice," a word that does not communicate a scienter requirement; (2) Congress has interpreted "device" in the context of § 15(c)(1) of the 1934 Act, 15 U.S.C. § 78o(c)(1) (1976), as including unintentional behavior; and (3) other statutes have given "device" a broad sweep. *Id.*

223. 425 U.S. at 199.

224. *Id.* at 1955. In fact, it appears generally agreed that "[t]here is nothing on the face of Clause (2) itself which smacks of *scienter* or intent to defraud." III L. LOSS, SECURITIES REGULATION 1442 (2d ed. 1961). *But see* Berner & Franklin, *supra* note 16, at 796-97 n.221.

225. *See* notes 155-60 *supra* and accompanying text.

226. 100 S. Ct. at 1955-56.

227. *See* notes 201-04 *supra* and accompanying text.

228. 375 U.S. at 200.

229. 100 S. Ct. at 1957.

230. Section 17(a) uses the phrase "[i]t shall be unlawful for any person in the offer or sale of any securities . . . ."

231. Ward La France Truck Corp., 13 S.E.C. 373, 381 (1943). Rule 10b-5 applies "in connection with the purchase or sale of any security."

enjoin a seller's unintentional misconduct. Justice Blackmun, in his *Aaron* dissent, denounced "this halfway-house approach" that "drives a wedge between" buyers and sellers.[232] Justice Blackmun stressed that this is the result of "the Court's technical linguistic analysis."[233] In the Court's defense, Chief Justice Burger, in his concurrence, stated that *Aaron* was compelled by *Hochfelder* and by the language of the anti-fraud provisions.[234] The Chief Justice noted that "if . . . the result [of the *Aaron* decision] is 'bad' public policy, that is the concern of Congress where changes can be made."[235]

As Justice Stewart noted, as recently as 1979 the Supreme Court had examined the differences among the three subparagraphs of section 17(a).[236] Justice Brennan, writing for the Court in *United States v. Naftalin*,[237] reasoned that "by the use of the infinitive 'to' to introduce each of the three subsections [of section 17(a)], and the use of the conjunction 'or' at the end of the first two, each subsection proscribes a distinct category of misconduct."[238]

One commentator has urged that the reach of section 17(a) need not be limited to sellers.[239] The same author emphasized that "the broader policies of the 1933 and 1934 Acts [to place buyers *and* sellers on equal footing] support treating them identically."[240]

B. *When Will an Injunction be Granted?*

The occurrence of past securities transgressions does not automatically give rise to injunctive relief.[241] Rather, the touchstone in a district court's calculus is whether there is a reasonable likelihood that a future violation will be committed.[242] Unlike a damages action, the purpose of an injunction is to prohibit continuing and future violations of the anti-fraud provisions.[243] An appeal to the equitable jurisdiction of the federal courts[244] permits a federal district court to weigh various factors,[245] such as the nature of the prior securities violations,[246] a past pattern of violations,[247] and the defendant's demeanor and cooperation,[248] when considering an injunctive

232. 100 S. Ct. at 1965.
233. *Id.*
234. *Id.* at 1958-59.
235. *Id.* at 1959.
236. *Id.* at 1956.
237. 441 U.S. 768 (1979).
238. *Id.* at 774 (footnote omitted).
239. *See generally The Scienter Requirement*, *supra* note 16, at 433-34.
240. *Id.* at 434 n.84 (footnote omitted).
241. *See* SEC v. Arthur Young & Co., 590 F.2d 785, 787 (9th Cir. 1979).
242. *E.g.*, SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100 (2d Cir. 1972); SEC v. Culpepper, 270 F.2d 241, 249 (2d Cir. 1959). Jaeger & Yadley, *Equitable Uncertainties in SEC Injunctive Actions*, 24 EMORY L.J. 639, 640 n.5 (1975).
243. SEC v. Management Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975).
244. "An appeal to the equity jurisdiction conferred on federal district courts is an appeal to the sound discretion which guides the determinations of Courts of equity." Meredith v. City of Winter Haven, 320 U.S. 228, 235 (1943).
245. *See generally* Harkleroad, *supra* note 16, at 491-96; Note, *Judicial Discretion*, *supra* note 16, at 343-53.
246. *See* SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).
247. *See* SEC v. Shapiro, 494 F.2d 1301, 1308 (2d Cir. 1974).
248. *See* SEC v. Pearson, 426 F.2d 1339, 1343 (10th Cir. 1970).

remedy.

The single most important measure used in the balancing scheme is the defendant's mental culpability.[249] While a showing of good faith may not conclusively bar injunctive relief,[250] proof of misrepresentations made in bad faith may present a formidable hurdle for the defendant.[251] Indeed, Chief Justice Burger observed in *Aaron* that "it will almost always be necessary for the Commission to demonstrate that the defendant's past sins have been the result of more than negligence."[252] Although the Chief Justice did not cite any authority, lower courts[253] and commentators[254] support his observation.

C. *The Role of Policy Considerations*

Both *Hochfelder*[255] and *Aaron*[256] found the statutory language and the legislative history of the securities acts sufficiently clear to preclude analysis of the policy arguments advanced. This is not to say, however, that policy considerations will not play a role under the securities statutes. Justice Rehnquist was eager to weigh policy considerations[257] when he determined the scope of standing under rule 10b-5 in *Blue Chip Stamps v. Manor Drug Stores*.[258] In addition, a district court, in the exercise of its equitable discretion, will still balance the public and private interests involved before issuing an injunction. Specifically, even after a trial court follows *Aaron's* holding on the scienter requirement and ultimately finds securities violations—at all times closing its eye to policy—the same court still must weigh the compet-

249. *See* Note, *Judicial Discretion*, *supra* note 16, at 343-46; Comment, *SEC Injunctive Suits*, *supra* note 16, at 1025-26. The Court in *Aaron* noted that "[a]n important factor . . . is the degree of intentional wrongdoing evident in a defendant's past conduct." 100 S. Ct. at 1958.

250. *See* Harkleroad, *supra* note 16, at 494. It must be remembered that this discussion of good faith is beyond the question of what constitutes a violation of § 17(a) or § 10(b).

251. *See, e.g.*, SEC v. Broadwall Sec., Inc., 240 F. Supp. 962 (S.D.N.Y. 1965).

252. 100 S. Ct. at 1959.

253. *See, e.g.*, SEC v. Blatt, 583 F.2d 1325, 1334-35 (5th Cir. 1978); SEC v. Wills, [1979 Decisions] FED. SEC. L. REP. (CCH) ¶ 96,712 at 94,771-72 (D.D.C. Dec. 14, 1978).

254. Two commentators have examined post-*Hochfelder* decisions and both conclude that not one court has issued an injunction without a showing of scienter: Lowenfels, *supra* note 16, at 790; *New Light on an Old Debate*, *supra* note 16, at 767 n.50.

As one commentator notes:

> [A] survey of the cases would indicate that for the most part injunctive relief has not been granted without an indication by the Court that the past conduct was willful. Therefore, no matter what the articulated standard, Courts seem generally to search for willful conduct upon which to base an injunction.

Brodsky, *Willfulness in SEC Enforcement Proceedings*, N.Y.L.J., Dec. 15, 1976, at 1, col. 1, at 2, col. 3 (footnote omitted).

Finally, in Katz & Nerheim, *Injunctive Proceedings and Ancillary Remedies Under Federal Securities Statutes*, in THE 10B SERIES OF RULES 183 (K. Bialkin ed. 1975) the authors quote Professor Loss: "[Y]ou bring out all the dirt you possibly can, about bad faith and the like, but that is not essential to the Court; it just helps you get the injunction." *Id.* at 195-96.

255. 425 U.S. 185, 214 n.33.

256. 100 S. Ct. at 1957 n.19.

257. Justice Rehnquist attacked the "vexatious" litigation in *Blue Chip Stamps* and expressed the need to delimit private 10b-5 suits, describing the action as a "judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores 421 U.S. 723, 737 (1975). *See generally* Note, *Judicial Retrenchment Under Rule 10b-5: An End to The Rule as Law?* 1976 DUKE L.J. 789, 798.

258. 421 U.S. 723 (1975).

ing policy goals in fashioning the appropriate remedy.[259] Accordingly, the competing interests, both public and private, will be examined here.

The underlying purpose of the 1933 Act is to protect investors by requiring full and accurate disclosure of all material information in connection with a public offering of securities.[260] The purpose of the 1934 Act is to protect investors from stock manipulations and to impose reporting requirements on certain companies.[261] Viewed in conjunction, these securities statutes are designed to foster market integrity and guard against the financial bilking of investors.[262]

The Commission is viewed as the "statutory guardian" of the investing public.[263] To the extent that the SEC must prove the defendant's intent to defraud, the evidentiary burden may obstruct Commission enforcement efforts.[264] The SEC was created with the intention that it possess flexible remedies deemed necessary for effective enforcement of the securities laws.[265] Moreover, the relief that the SEC seeks, a statutory injunction, has an objective quite different from a private damages action. An injunction is aimed not at punishing past wrongdoing[266] but at protecting the public against recurring and future securities violations.[267] The injunction is "prophylactic" in nature.[268]

An injunction, it is argued, also has a general deterrent function. The Supreme Court, in an unrelated context, stated that "[t]he historic injunctive process was designed to deter, not to punish."[269] Nevertheless, the deterrence value of an injunction based on negligent violations of the antifraud provisions seems questionable. Indeed, it may be that negligent misrepresentations defy control by the injunctive method.[270] It seems implausible that an injunction could successfully enjoin negligent misstatements that, by definition, are inadvertent and unintentional.[271]

Perhaps the most oft-repeated policy in support of the issuance of an injunction based on negligent conduct is that "it would be preferable to place liability for negligent misstatements on the shoulders of those responsible for their dissemination rather than to require innocent investors to suffer

259. *See* SEC v. World Radio Mission, Inc., 544 F.2d 535, 541 (1st Cir. 1976). *See generally* GA. L. REV., *supra* note 15, at 896-98. Once a past violation has been proved, "no *per se* rule requires that an injunction issue." SEC v. Arthur Young & Co., 590 F.2d 785 (9th Cir. 1979).

260. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

261. *Id.*

262. *See, e.g.*, SEC v. World Radio Mission, Inc., 544 F.2d 535, 540-41 (1st Cir. 1976); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1095-97 (2d Cir. 1972).

263. *See* SEC v. Management Dynamics, Inc., 515 F.2d 801, 808-09 (2d Cir. 1975); *See also* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 5 (1934).

264. *See* SEC v. Shiell, [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,190, at 92,386 (N.D. Fla. Sept. 27, 1977).

265. *See* S. REP. NO. 792, 73d Cong., 2d Sess. 5 (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 7 (1934).

266. The purpose of damages is to punish the wrongdoer and to make the defrauded investor whole. *See generally* W. PROSSER, HANDBOOK OF THE LAW OF TORTS 2, 9 (4th ed. 1971).

267. *E.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972).

268. SEC v. J. & B. Indus., Inc., 388 F. Supp. 1082, 1084 (D. Mass. 1974).

269. Hecht Co. v. Bowles, 321 U.S. 321, 329 (1944).

270. *See generally New Light on an Old Debate*, *supra* note 16, at 781-82.

271. *See* SEC v. Universal Major Indus., 546 F.2d 1044, 1047 (2d Cir. 1976).

in silence."[272] As a corollary to this philosophy, it is urged that the effect of a misrepresentation is the same regardless of whether the misinformation resulted from a negligent mistake or a fraudulent design.[273]

What this argument fails to recognize, however, is the countervailing considerations of policy. First, the Supreme Court in *Hochfelder* noted that "[t]he logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors."[274] Indeed, since an investor's loss is identical whether the defendant's misrepresentation was *purely innocent* or negligent, should a court also impose an injunction for *innocent* misstatements to better protect investors? However one answers this question, it illustrates a second countervailing policy interest: There are social costs associated with strengthening the protections granted the investing public.[275] In short, there are tradeoffs.

Undoubtedly, the more the culpability standard is relaxed, the more protection investors receive. But exactly how much additional protection? Investors, as a group, can be divided roughly into four classes: those subject to purely faultless misrepresentations, those subject to intentional misrepresentations, those subject to negligent misrepresentations, and those not subject to any misrepresentations. Of course, the incremental benefits of an injunction based on negligent securities violations accrue exclusively to that class of investors victimized by *negligent* misrepresentation.[276] The benefits flowing to that particular class of investors should be balanced against the aggregate costs of enjoining negligent misconduct. The Roosevelt Administration intended the 1933 Act to achieve its goals with the least possible disruption of genuine business interests.[277] Courts may properly consider the burden imposed upon a defendant when an injunction issues on the basis of negligent conduct.[278] The social cost all investors must bear, at least indirectly,[279] stemming from an unintentional culpability standard is the additional expense to securities dealers for insurance to cover their expanded liability exposure.[280]

A more important countervailing policy is that a sanction should be

272. Aaron v. SEC, 100 S. Ct. 1945, 1965 n.5 (1980) (Blackmun, J., dissenting).

273. *Id. See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); 3 A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 8.4(508) at 204.11 to -.112 (1977).

274. 425 U.S. at 198.

275. *See generally* Note, *Securities Regulation*, 5 J. CORP. L. 377, 391-94 (1980) [hereinafter cited as Note, *Securities Regulation*].

276. Those investors bilked by innocent, *i.e.*, non-negligent, misstatements probably would have no recourse under § 17(a) or § 10(b). Those investors harmed by intentional misrepresentations would receive no additional protection because they would be covered under either a negligence or a scienter culpability standard. Finally, that class of investors not encountering any securities swindle needs no protection.

277. Message From the President—Regulation of Securities Issues, 77 CONG. REC. 937 (1933). *See generally* Note, *Securities Act 17(a)*, *supra* note 160, at 1262-63 n.150.

278. *See* A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 8.4(508), at 204.113-.114 (1977).

279. An implicit assumption is that, in the long run, securities dealers will be able to shift to their clients, in full or part, any increased operating expenses incurred throughout the industry.

280. *See* Note, *Securities Regulation*, *supra* note 275, at 392.

commensurate with the defendant's culpability.[281] Accordingly, at common law the ambit of an actor's tort liability was contingent upon whether the defendant made intentional or negligent misrepresentations.[282] In light of this policy, a court's inquiry should focus, not solely on the investor's injury, but on whether the sanction bears some reasonable relationship to the actor's mental culpability.[283] The upshot is that a trial court should carefully examine the consequences of an injunction vis-à-vis the defendant's unintentional misstatement.

Some courts, especially in the early decisions,[284] glossed over the serious burdens imposed by injunctions.[285] Recently, however, courts[286] and commentators[287] have re-examined the impact of SEC injunctions. Unquestionably, under some circumstances, injunctive relief cannot be accurately characterized as a "mild" sanction.

The immediate result of an injunction is that the defendant is under a court order to comply with the anti-fraud provisions. Failure to comply may result in civil or criminal contempt proceedings.[288] The sanctions against the individual include: disqualification of an attorney or accountant from professional practice before the SEC under a rule 2(e) proceeding;[289] suspension or revocation of a broker-dealer's registration;[290] and disqualifications under the 1933 Act and the IAA.[291] The rule 2(e) proceeding can be particularly distressing. The Commission may, under paragraph (3) of rule 2(e), "temporarily suspend" any attorney or accountant who has been "permanently enjoined" from violating federal securities laws.[292] This suspension is *without* notice or hearing.[293] Furthermore, although the suspension is labeled "temporary," to lift it, the professional must: 1) file a petition within

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281. *See, e.g.*, Ultramares v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931). *See generally* GA. L. REV., *supra* note 15, at 894-99.

282. GA. L. REV., *supra* note 15, at 895.

283. *See* 5 A. JACOBS, THE IMPACT OF RULE 10b-5 § 63, at 3-161 to -162 (rev. ed. 1976).

284. *Capital Gains* characterized an injunction as a "mild prophylactic." 375 U.S. 180, 193 (1963).

285. *E.g.*, Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 n.6 (2d Cir. 1976).

286. *See, e.g.*, SEC v. Caterinicchia, 613 F.2d 102, 105 (5th Cir. 1980) (district court had characterized an injunction as an "extraordinary measure"); SEC v. Petrofunds, Inc., 414 F. Supp. 1191, 1198 (S.D.N.Y. 1976) (noted "harmful impact of a receiver and an injunction on the legitimate activities of the defendant").

One district court noted:

> Despite SEC arguments to the contrary, what it seeks is more than a mere prophylactic related to the specific facts of the case. The broad, all-encompassing injunction sought here against any conceivable future violations carries the strong inference that the court believes the defendants *would* violate the law but for the court's intercession . . . .

SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1245 (S.D.N.Y. 1976), *aff'd on other grounds*, 565 F.2d 8 (2d Cir. 1977).

287. *See* Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105 (Sp. Issue, Mar. 1975); Note, *Judicial Discretion*, *supra* note 16, 340-43; *New Light on an Old Debate*, *supra* note 16, at 780-81.

288. *E.g.*, Frank v. United States, 395 U.S. 147 (1969).

289. 17 C.F.R. § 201.2(e)(3)(i) (1979). *See generally* Marsh, *Rule 2(e) Proceedings*, 35 BUS. LAW. 987, 993-94 (1980).

290. Sections 15(b)(5) and (7) of the 1934 Act, 15 U.S.C. § 78o(b)(5), (7) (1976).

291. *See generally* Berner & Franklin, *supra* note 16, at 785-86.

292. 17 C.F.R. § 201.2e(3) (1979).

293. Marsh, *supra* note 289, at 999-1001.

thirty days after being served with the order; and 2) bear the burden of convincing the Commission that he or she should not be censured.[294] Even worse, the consequences of being suspended from practicing before the SEC are not de minimis. Apparently, the Commission considers any services rendered in connection with the federal securities laws to be included within the suspended activities.[295] In effect, a rule 2(e) suspension could be the end of a security attorney's livelihood.

The comparable penalties against the corporation include the loss of business, the injury to reputation,[296] and the possible disclosure of the injunction in mandatory Commission and shareholder reports.[297] In addition, the Commission has certain ancillary remedies at its disposal, such as disgorgement of profits, rescission, and appointment of a receiver.[298] Aside from the above punitive aspects of an SEC enforcement action, the legal fees of defending against the injunction are usually very high.[299] In the face of all this, some commentators have argued that especially if the defendant is a securities lawyer, the imposition of an injunction is a more stinging sanction than a private damages action, which might be covered, at least in part, by insurance.[300]

CONCLUSION

The *Aaron* decision seems compelled by the Court's holding in *Ernst & Ernst v. Hochfelder* and the statutory language of the anti-fraud provisions of the securities laws. Indeed, the *Hochfelder* Court's reading of the language of section 10(b) of the 1934 Act must have universal application—regardless of the identity of the plaintiff or the nature of the relief sought. Viewing the text of sections 17(a)(2) and (3) of the 1933 Act, the *Aaron* Court could not find language indicating that scienter is necessary to constitute a violation of these provisions. Nevertheless, the Supreme Court recognized that a past securities violation does not automatically give rise to injunctive relief. Rather, a district court, in exercising its equitable discretion, must focus on the likelihood of future violations. A key, if not decisive, factor in the district

294. 17 C.F.R. § 201.2(e)(3) (1979). *See generally* Marsh, *supra* note 289, at 1012-13. Professor Marsh succinctly notes:

> The Commission has constantly argued before the Courts that no one should object to being subjected to the "mild prophylactic" of being enjoined against violating the law; and that, if he has no present intention of doing so in the future, he should not resist being required to conform to the law by order of the Court. However, in the next breath the Commission, under this Rule, has asserted the right to deprive a professional subject to such an injunction of his right to practice solely as a result of the injunction having been entered, unless he can carry the "burden of proof" of convincing them that he is not deserving of this punishment.

Id. at 1013.

295. Marsh, *supra* note 289, at 993-95.

296. Bauman, *The Future of Rule 10b-5: A Comment on Jacobs, The Impact of Rule 10b-5*, 4 SEC. REG. L.J. 332, 345 (1976).

297. *See* Note, *Judicial Discretion*, *supra* note 16, at 342.

298. *See generally* Jacobs, *Judicial and Administrative Remedies Available to the SEC For Breaches of Rule 10b-5*, 53 ST. JOHN'S L. REV. 397 (1979).

299. *See* Griggin, *The Beleagured Accountants: A Defendant's Viewpoint*, 62 A.B.A.J. 759, 761 (1976).

300. *See* Berner & Franklin, *supra* note 16, at 785-86; Mathews, *supra* note 287, at 107.

court's balancing of the public and private interests involved will be the defendant's mental culpability. Therefore, the battleground in securities litigation seems to have shifted away from whether scienter constitutes a securities violation to whether a finding of scienter is crucial before a trial court may grant an injunction.

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