

CASENOTES

Standard of Proof in SEC Actions for Injunctive Relief in Securities Fraud Cases: *S.E.C. v. First Financial Group of Texas*¹ — The appropriate standard of proof in Securities and Exchange Commission (SEC) civil enforcement actions for injunctive relief has not often been a point of contention. The language of the Securities Act of 1933 (the 1933 Act)² and the Securities Exchange Act of 1934 (the 1934 Act)³ grants to the SEC the right to seek an injunction upon a "proper showing" that there is a reasonable likelihood that the defendant is engaged in or is about to engage in practices that violate the federal securities laws.⁴ Until recently, however, courts have not interpreted this language in connection with sufficiency of proof.⁵ In 1978, the District of Columbia Circuit Court of Appeals for the first time articulated a standard of proof in an action by the SEC to enjoin violations of the federal securities laws. In *SEC v. Savoy Industries*,⁶ the court held that the appropriate standard of proof in actions for injunctions against reporting violations was a preponderance of the evidence.⁷ The court reasoned that because an injunction was remedial in

¹ 645 F.2d 429 (5th Cir. 1981).

² The 1933 Act is codified in 15 U.S.C. §§ 77a-77bbbb (1976).

³ The 1934 Act is codified in 15 U.S.C. §§ 78a-78kk (1976).

⁴ The SEC is permitted to bring civil enforcement actions for injunctive relief under § 20(b) of the 1933 Act and § 21(e) of the 1934 Act. Section 20(b), 15 U.S.C. § 77t(b) (1976) provides in pertinent part:

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 title, 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.

Section 21(e), 15 U.S.C. § 78u(d) (1976) provides in pertinent part:

(e) Upon application of the Commission the district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any territory or other place subject to the jurisdiction of the United States shall have jurisdiction to issue writs of mandamus, injunctions, and orders commanding (1) any person to comply with the provisions of this title, the rules, regulations, and orders thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or person associated with a member, the rules of a registered clearing agency in which such person is a participant, the rules of the Municipal Securities Rulemaking Board, or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title. . . .

⁵ Some courts have discussed the standard of proof required in SEC injunctive actions in terms of the elements required. *See, e.g., SEC v. Aaron*, 446 U.S. 680, 701-02 (1980) (scienter required for certain violations); *SEC v. Capital Gains Research Bureau*, 300 F.2d 745, 746 (2d Cir. 1961) (convincing proof of irreparable injury required), *aff'd*, 375 U.S. 180 (1963); *SEC v. Waco Fin. Inc.*, 518 F. Supp. 651, 654 (S.D. Mich. 1981) (showing of irreparable injury not required).

⁶ *SEC v. Savoy Indus.*, 587 F.2d 1149 (D.C. Cir. 1978) (injunction sought for violation of reporting provision of Securities Exchange Act of 1934).

⁷ *Id.* at 1169.

nature and resulted in a less than severe detriment to the defendant, a higher burden of proof was not warranted.⁸

The Fifth Circuit Court of Appeals, in 1981, became the first court to establish specifically a standard of proof in actions for injunctive relief against violations of the anti-fraud provisions of the securities laws. In *SEC v. First Financial Group of Texas*, the court announced that the standard of proof for preliminary injunctive relief in securities fraud cases also was a preponderance of the evidence.⁹ The defendant¹⁰ in *First Financial*, First Financial Group of Texas (First Financial), was a dealer¹¹ in securities.¹² It offered and sold to the public securities with an aggregate value of nine million dollars.¹³ These securities were packages of student loans and repurchase agreements.¹⁴ Under the agreements, First Financial was to deposit the securities in safekeeping with third parties until a specified date when it would repurchase the securities at an increase in value.¹⁵ The defendant, however, did not deposit the securities in safekeeping and defaulted on the repurchase agreements.¹⁶ After First Financial defaulted on the repurchase agreements, the SEC brought a civil enforcement action in the Federal District Court for the Southern District of Texas, alleging violations¹⁷ of section 17(a) of the 1933 Act,¹⁸ section 10(b) of the 1934

⁸ *Id.* at 1168-69.

⁹ 645 F.2d at 435.

¹⁰ Two other defendants, Reynolds and Howton, officers at First Financial, were also included in the action. *Id.* at 432. Their appeals from the preliminary injunction prohibiting them from disposing of their personal assets beyond \$1500 per week per individual were dismissed as moot by the Court of Appeals because a permanent injunction had already issued. *Id.* at 432-33.

¹¹ 15 U.S.C. § 78c(a)(5) (1976), a provision of the 1934 Act, provides: The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

See also 15 U.S.C. § 78c(a)(4) (1976) (definition of broker).

¹² 645 F.2d at 431.

¹³ *Id.*

¹⁴ The student loans were made by financial institutions to college students and were guaranteed by a federal agency. *Id.* at 431 n.3. The repurchase agreements bound the defendant to repurchase the student loans from the purchasers at a future date for an amount reflecting a profit to the purchaser of 11% per annum interest for the period between the purchase of the loan and its repurchase by the defendant. *Id.*

¹⁵ *Id.* at 431.

¹⁶ *Id.* at 432.

¹⁷ *Id.*

¹⁸ Section 17(a) of the 1933 Act, 15 U.S.C. § 77q (1976) provides:

SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(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 the light of the circumstances under which they were made, not misleading, or

Act,¹⁹ and rule 10b-5.²⁰ The SEC sought to enjoin the defendant from continuing to offer and sell the securities to the public.²¹ In addition, the SEC requested interlocutory relief, including a preliminary injunction and the appointment of a temporary receiver.²²

After a hearing,²³ the trial court issued a preliminary injunction which prohibited First Financial from offering, purchasing or selling the securities in violation of the securities laws and from disposing of its assets and records.²⁴ First Financial appealed the issuance of the injunction, alleging that the district court erred in failing to require clear and convincing evidence of its violations of the anti-fraud provisions.²⁵ The Court of Appeals for the Fifth Circuit rejected the defendant's arguments and affirmed the district court's order granting a preliminary injunction.²⁶ It held that proof by a preponderance of the evidence was the appropriate standard for preliminary injunctions in securities

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

¹⁹ Section 10(b), 15 U.S.C. § 78j(b) (1976) provides:

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

²⁰ 645 F.2d at 432. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1981) provides:

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

(1) to employ any device, scheme, or artifice to defraud,

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

(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 purchase or sale of any security.

²¹ 645 F.2d at 432.

²² *Id.* The receiver was requested in order to prevent irreparable loss to the investors and to protect their interests. *Id.*

²³ Prior to the hearing, the defendant filed a motion to suppress allegedly illegally obtained evidence furnished by a creditor to the SEC. *Id.* The district court proceeded with the hearing on the preliminary injunction, postponing decision on the motion to suppress over the objections of the defendant. *Id.*

²⁴ *Id.* Twelve days later a temporary receiver was appointed (five days after a petition for involuntary bankruptcy had been filed against the defendant). *Id.*

²⁵ *Id.* Other errors alleged were: 1) the district court's failure to make specific factual findings of scienter and a lack of evidence to support such a finding; 2) the district court's refusal to rule on the defendant's motion to suppress evidence prior to the hearing and decision on the SEC's motion for preliminary injunction; 3) the district court was without jurisdiction to appoint a receiver once an involuntary petition in bankruptcy had been filed. *Id.* at 435-40. The Fifth Circuit Court of Appeals rejected these allegations of error and affirmed the district court's orders. *Id.*

²⁶ *Id.* at 434-35, 440.

fraud actions brought by the SEC.²⁷

The *First Financial* court's decision was based on a balancing of the individual defendant's interest in avoiding an injunction against the public's interest in effective protection against future harm.²⁸ The *First Financial* court noted that the individual's interest in avoiding an injunction did not outweigh the "significant public interest in effectively policing the securities industry and preventing future securities frauds."²⁹ Furthermore, the court observed that the deprivation that the defendant was likely to suffer from an injunction, namely an inability to commit future violations of the securities laws, was insufficient to justify a departure from the preponderance standard.³⁰ Consequently, it held that the proper standard for SEC civil enforcement actions in securities fraud cases, "particularly where preliminary injunctive relief is involved," was a preponderance of the evidence standard.³¹ This language, however, leaves unclear whether the court's holding is to be limited to actions for preliminary injunctions or whether the preponderance standard is to be applied in all actions for injunctive relief against securities fraud. If the standard were intended for use in all actions for injunctive relief, the court would have been merely expressing an opinion that the standard was especially suited to a preliminary injunction. Under such an interpretation, preliminary injunctions would be presumed to have a less detrimental impact on the defendant because of their temporary nature. This casenote will demonstrate that this interpretation, that the preponderance standard should be applied to all injunctions against securities fraud, is the one that should be given effect and followed in future cases.

First Financial is significant because it involves the first challenge to the traditional assumption that the preponderance standard of proof applies to civil enforcement actions for injunctive relief for securities fraud.³² In this first judicial consideration of the issue, the *First Financial* court rejected a proposed increase in the standard of proof.³³ This holding is confirmed by an in-depth analysis of the competing interests of the defendant and the public in the outcome of the litigation. In addition, the contrast between common law and securities fraud and the existence of procedural safeguards prerequisite to the issuance of a securities injunction lend further support to the court's conclusion. By enunciating the applicability of a preponderance standard to securities fraud injunctions, for the first time, *First Financial* has begun to resolve uncer-

²⁷ *Id.* at 435.

²⁸ *Id.* at 434.

²⁹ *Id.* at 435.

³⁰ *Id.* The temporary, tentative nature of a preliminary injunction was a factor in the court's decision. *Id.* at 435 n.8.

³¹ *Id.* at 435.

³² Until recently, courts had assumed that the usual standard for civil actions, the preponderance standard, was appropriate for securities injunctions and thus had not discussed the burden of proof in terms of the sufficiency of evidence. The courts had, however, addressed the issue of certain other elements of the standard of proof. *See* cases cited *supra* at note 5.

³³ 645 F.2d at 434-35.

tainty about the appropriate standard of proof in such actions. *First Financial* thus has led the way for other federal courts to establish as a uniform burden of proof for all civil enforcement actions for injunctions against securities fraud, the standard of a preponderance of the evidence.

This casenote will first outline the balancing of interests test used by courts to determine applicable standards of proof. In connection with the balancing test, the uses and functions of the three most commonly used standards of proof will be reviewed. This review will suggest that an equal allocation of the risk of erroneous decision through a preponderance standard in the securities fraud area is in keeping with a broad principle behind the determination of appropriate standards of proof in other substantive areas of law. This broad principle is the policy preference for shifting the risk of erroneous decision, through an increase in the standard of proof, away from the defendants as their interests gain in importance. Next, a general description of the SEC civil enforcement action for injunctive relief and its standard of proof will be outlined. In this context, the *First Financial* court's decision will be discussed. It will be argued that the preponderance standard is the appropriate standard of proof for all injunctions sought by the SEC for violations of federal securities anti-fraud statutes. Then, the interests of defendants will be described in detail. These interests are shown to arise from the direct and indirect consequences of an injunction. The public's interest in protection against securities fraud also will be outlined. Next, this casenote will discuss two additional factors important in the determination of an appropriate standard of proof for SEC suits for anti-fraud injunctions. These two factors involve a comparison of securities fraud and common law fraud and an examination of the contrast between SEC injunctions and traditional equity injunctions. An analysis of the competing interests of individual defendants and the investing public as well as these two influential factors will suggest that the public's interests should outweigh the individual's. Based upon this analysis and critique, it will be submitted that the holding in *First Financial*, that the preponderance standard is appropriate for preliminary injunctions, should be extended to include all injunctive relief requested by the SEC for violations of the anti-fraud provisions. An equal allocation of the risk of an erroneous decision would best balance the competing interests of the investing public and the individual defendant.

I. STANDARDS OF PROOF

A general examination of available standards of proof provides a useful background for determining which of the existing standards of proof is the most appropriate for SEC injunctive actions. First, the balancing of interests test for determining an appropriate standard of proof will be outlined. Then, the three most common standards, the preponderance standard, the standard of clear and convincing evidence, and proof beyond a reasonable doubt will be described. The allocation of the risk of erroneous decision and the importance of the defendant's interests will be identified for each of the three standards.

In *Addington v. Texas*,³⁴ the United States Supreme Court commented that the standard of proof applied in a particular case "serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision."³⁵ Traditionally, in the absence of Congressional prescription,³⁶ the appropriate degree of proof required is a matter for judicial determination.³⁷ The *Addington* case involved the appropriate standard of proof for involuntary commitment in a civil case.³⁸ To determine the correct burden of proof for the state, the court devised a balancing test. Under this test, the individual's interest in not being involuntarily confined was weighed against the state's interest in committing the emotionally disturbed.³⁹ Although the *Addington* court specifically addressed the issue of what standard of proof was to be applied in a civil commitment hearing, the same balancing of public interests against the interests of the defendant has been applied in the securities area.⁴⁰ In the securities cases, the balance was between the public interest in protection against securities fraud and the individual's interest in avoiding the particular sanction sought by the SEC.⁴¹

The courts have employed three basic standards of proof in civil and criminal proceedings.⁴² The selection of the standard has, in each type of case, related to the outcome of a determination test such as the balancing of interests test. Generally, when the interests of the defendant have outweighed the

³⁴ 441 U.S. 418 (1979).

³⁵ *Id.* at 423. In his concurring opinion, Justice Harlan stated: "[i]n the realm of fact-finding, the standard of proof acts to instruct the fact-finder concerning the degree of confidence our society thinks he should have in the correctness of factual conclusions for a particular type of adjudication." *Id.* at 423 (quoting *In re Winship*, 397 U.S. 358, 370 (1970) (Harlan, J., concurring)).

³⁶ Absent constitutional concerns, the courts are bound to a standard of proof if it is dictated by Congress. *Steadman v. SEC*, 450 U.S. 91, 95 (1981).

³⁷ *Woodby v. Immigration and Naturalization Service*, 385 U.S. 276, 284 (1976).

³⁸ *Addington v. Texas*, 441 U.S. 418, 425 (1979).

³⁹ *Id.*

⁴⁰ See cases cited *infra* at note 41. The proper allocation of risk of error is particularly suited to a comparison of interests. As the balance shifts toward the individual, the allocation of risk may be shifted away. Such a sliding scale type of test seems more appropriate than a one-step determination of whether an interest meets a certain threshold level of importance because of the broad category of interests involved both on the public side as well as the individual's side.

⁴¹ See, e.g., *SEC v. First Fin.*, 645 F.2d 429, 434-35 (5th Cir. 1981) (balancing test applied in securities injunction action); *Decker v. SEC*, 631 F.2d 1380, 1384 (10th Cir. 1980) (balancing test applied in administrative proceeding). In cases where no personal hardship is involved, the standard can be established by the likelihood of the truth of the general type of claim. See, e.g., *General Motors Corp. v. Toyota Motor Co.*, 467 F. Supp. 1142, 1173-74 n.159 (S.D. Ohio 1979). The identity of the litigants is not relevant in such cases. *Id.* See Case Comment, *Scope of Review or Standard of Proof — Judicial Control of SEC Sanctions: Steadman v. SEC*, 93 HARV. L. REV. 1845, 1852 n.66 (1980).

⁴² There is some question as to the difference in the practical effect of the three different standards. See *Addington v. Texas*, 441 U.S. 418, 424-25 (1979). The courts, however, have held that "adopting a 'standard of proof is more than an empty semantic exercise.'" *Id.* at 425 (quoting *Tippett v. Maryland*, 436 F.2d 1153, 1166 (4th Cir. 1971) (Sobeloff, J., concurring and dissenting), cert. dismissed sub nom., *Murel v. Baltimore City Criminal Court*, 407 U.S. 355 (1972)).

public's interest, the standard of proof chosen has been more restrictive than the preponderance standard. The least restrictive standard is the preponderance of the evidence standard, used in most civil proceedings involving private disputes for damages.⁴³ When the preponderance standard is applied, the trier of fact must believe that it is more probable than not that the facts presented by the plaintiff are true or exist.⁴⁴ The preponderance standard allocates equally between the litigants the risk of an erroneous decision and indicates the minimal societal interest in the outcome of such disputes between private individuals.⁴⁵ The standard also may be applied when the action involves a regulatory agency acting in the public interest.⁴⁶

An intermediate standard is the standard of clear and convincing evidence.⁴⁷ Under this standard, the trier of fact must believe that it is highly probable that the facts presented by the moving party are true.⁴⁸ Although it is "no stranger to the civil law,"⁴⁹ the intermediate standard is used less frequently than the other evidentiary standards of a preponderance of the evidence and proof beyond a reasonable doubt.⁵⁰ It has been employed primarily in civil fraud cases.⁵¹ Applying a higher standard of proof than is normally used

⁴³ 9 WIGMORE, EVIDENCE (Chadbourn rev. 1981) § 2498 n.1.

⁴⁴ McBaine, *Burden of Proof: Degrees of Belief*, 32 CALIF. L. REV. 242, 261 (1944).

⁴⁵ Addington v. Texas, 441 U.S. 418, 423 (1979).

⁴⁶ When a strong public interest, promoted by a regulatory agency such as the SEC, is balanced against a lesser individual interest (*see infra* notes 152-67 and accompanying text), use of the preponderance standard appears justified. *See generally* McBaine, *supra* note 44, at 242 (discussing shifts in the allocation of risk as a function of the importance of the defendant's interests). Although an allocation of the risk of erroneous decision may be shifted away from the defendant, it is never shifted toward him, regardless of the importance of the competing interest. At most, the standard of proof will mandate an equal allocation of the risk. *Id.* Moreover, the preponderance standard has traditionally been employed because most administrative proceedings have been regarded as civil and remedial in nature. WIGMORE, *supra* note 43, at § 2498. The preponderance standard was first adopted by the SEC for use in administrative proceedings in *In re White*, 3 S.E.C. 466 (1938). In that case, the SEC held that proceedings for a suspension or expulsion were "closely analogous to proceedings for the collection of a statutory penalty" and thus were of a civil rather than a criminal nature. *Id.* at 539-40. Consequently, issues of fact were to be proven "according to a reasonable preponderance of the evidence." *Id.*

⁴⁷ This standard appears under different combinations of terms, usually including some or all of the following: clear, convincing, cogent, unequivocal. MCCORMICK, EVIDENCE § 340(b) (2d ed. 1972). Although courts have not agreed on the precise position this standard occupies in the continuum of standards, it generally refers to a standard greater than a preponderance but not so great as beyond a reasonable doubt. *See* McBaine, *supra* note 44, at 251-54. Some courts have tried to push this intermediate position closer to one of the polar positions by adding or deleting one of the above terms. *See, e.g.,* Collins Sec. Corp. v. SEC, 562 F.2d 820, 824 (D.C. Cir. 1977) (clear, unequivocal and convincing evidence is a higher burden than clear and convincing evidence).

⁴⁸ McBaine, *supra* note 44, at 262-63.

⁴⁹ *Woodby v. Immigration and Naturalization Service*, 385 U.S. 276, 285 (1966).

⁵⁰ Addington v. Texas, 441 U.S. 418, 424 (1979).

⁵¹ *E.g.,* American Cyanamid Co. v. Electrical Indus., Inc., 630 F.2d 1123, 1127 (5th Cir. 1980) (clear and convincing evidence standard); Norton Co. v. Carborundum Co., 530 F.2d 435, 444 (1st Cir. 1976) (clear, unequivocal and convincing evidence); Goodman v. Poland, 395 F. Supp. 660, 686 n.17 (D. Md. 1975) (clear and convincing evidence); Allensworth v. Ben Franklin Sav. & Loan Ass'n, 71 Ill. App. 3d 1041, 1044, 389 N.E.2d 684, 687 (1979)

for civil actions to such cases has been justified on the basis of the quasi-criminal nature of a fraud action and the typical reliance in such cases on circumstantial evidence.⁵² In addition, the courts have recognized that allegations of fraud "might seriously damage [one's] standing and associations in [the] community."⁵³ As a result, the clear and convincing standard of proof has been imposed in deference to the "adverse social consequences to the individual of . . . a fraud conviction."⁵⁴ Thus, in civil fraud cases, the individual defendant's interests are significant enough to require a shift in the allocation of the risk of erroneous decision to the plaintiff.⁵⁵

The most rigorous standard is that of proof beyond a reasonable doubt.⁵⁶ This standard is applied primarily in criminal proceedings.⁵⁷ Under this standard, the prosecution bears the burden of persuading the trier of fact to believe to a point of almost certainty, or beyond a reasonable doubt, the truth of all facts essential to the crime.⁵⁸ The interests of the criminal defendant in life and liberty are considered of such importance that they have been constitutionally protected by the standard of proof beyond a reasonable doubt under the due process clause of the Fourteenth Amendment of the United States Constitution.⁵⁹ Thus, the balance of interests in criminal cases has been weighted heavily in favor of the individual's interest in retaining his life and liberty.⁶⁰ As a

(clear and convincing evidence). *But see* *Jensen v. Sohler*, 601 F.2d 353, 354 (8th Cir. 1979) (preponderance of the evidence); *Blaeser Development Corp. v. First Federal Sav. & Loan Ass'n*, 375 So. 2d 1118, 1118 (Fla. Dist. Ct. App. 1979) (preponderance standard).

⁵² *Addington v. Texas*, 441 U.S. 418, 423-24 (1979). The Court noted that [o]ne typical use of the standard is in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof.

Id. at 423-24.

The first use of the clear and convincing standard of proof was in English equity cases involving parole evidence. The court's concern over the quality of evidence led it to develop a burden of proof higher than the traditional preponderance standard. *See, e.g.*, *Townshend (The Marquis) v. Stangroom*, 31 Eng. Rep. 1076 (Ch. 1801); *Henkle v. Royal Exch. Assurance Co.*, 27 Eng. Rep. 1055 (Ch. 1749). The need to rely on circumstantial evidence in common law fraud cases also has been proposed as a justification for employing the clear and convincing standard in such cases. *See, e.g.*, *Smith v. Rhode Island Co.*, 39 R.I. 146, 154, 98 A. 1, 4 (1916). Use of circumstantial evidence alone usually is, however, insufficient cause to resort to a higher standard of proof. *See, e.g.*, *General Exch. Ins. Corp. v. Edwards*, 181 Okla. 288, 290, 73 P.2d 1145, 1147 (1937); *Roedinger v. Union Pacific R. Co.*, 95 Kan. 146, 151, 147 P. 837, 839 (1915).

⁵³ *McNeill v. Butz*, 480 F.2d 314, 319 (4th Cir. 1973) (quoting *Board of Regents v. Roth*, 408 U.S. 564, 573 (1972)).

⁵⁴ *Addington v. Texas*, 441 U.S. 418, 426 (1979).

⁵⁵ *Id.* at 424.

⁵⁶ *McBaine*, *supra* note 44, at 255.

⁵⁷ *WIGMORE*, *supra* note 43, at § 2497. The standard has been applied in a few non-criminal proceedings, particularly in illegitimacy cases. *McBaine*, *supra* note 44, at 255 n.25; *see also* *WIGMORE*, *supra* note 43, at § 2498 for citations of civil actions where this standard has been applied.

⁵⁸ *McBaine*, *supra* note 44, at 265.

⁵⁹ *In re Winship*, 397 U.S. 358, 364 (1970).

⁶⁰ *See id.*

result, the standard of proof has been designed to eliminate almost all likelihood of erroneous conviction.⁶¹ The standard of proof beyond a reasonable doubt allocates the risk of an erroneous decision almost entirely to the prosecuting state.⁶²

In summary, a standard of proof serves to allocate between the litigants the risk of an erroneous decision. It varies along a continuum ranging from the least restrictive, preponderance of the evidence, standard to the most restrictive, proof beyond a reasonable doubt, standard in accordance with the individual and public interests involved. As the individual defendant's interest gains in importance or the public's or plaintiff's interest declines, the court may shift the allocation of the risk of erroneous decision away from the defendant and increase the degree of proof required. At common law, the standard in civil fraud cases is firmly established as clear and convincing evidence. The standard for such actions when brought by the SEC for violations of the anti-fraud provisions of the securities laws, however, is less certain. In this area, due to a lack of a congressionally mandated standard of proof (other than "a proper showing"⁶³) the judiciary has been left to determine the appropriate standard of proof. The *Addington* balancing test has been applied by federal courts in the securities area⁶⁴ and seems particularly well-suited to securities actions. The flexibility of this balancing test fits in well with the range of interests that a particular defendant may have and which are in competition with the public interest in protection against securities fraud. Applying the *Addington* test to SEC actions for injunctive relief demonstrates that the equal allocation of the risk of erroneous decision found in the preponderance standard is the most appropriate burden for the SEC to bear.

II. A PREPONDERANCE STANDARD FOR SEC ACTIONS FOR INJUNCTIVE RELIEF

The 1933 and 1934 Acts provide the SEC with the option to seek injunctive relief in a civil enforcement action.⁶⁵ Under the statutory language, the SEC must make a "proper showing" that there is a reasonable likelihood that the defendant is engaged in or is about to engage in practices that violate the federal securities laws.⁶⁶ Until recently, however, courts had not addressed the

⁶¹ See *Addington v. Texas*, 441 U.S. 418, 423-24 (1979).

⁶² *Id.*

⁶³ See *infra* notes 66-67 and accompanying text.

⁶⁴ See cases cited *supra* note 41.

⁶⁵ Section 21(e), 15 U.S.C. § 78u(d) (1976). Relief under section 21(e) is, in fact, the only civil non-administrative remedy available to the SEC. For the text of this provision, see *supra* note 4.

⁶⁶ *Aaron v. SEC*, 446 U.S. 680, 699 (1980); 3 L. LOSS, *SECURITIES REGULATION*, 1975, 1976-81 (2d ed. 1961). Some courts, in addressing the issue of the likelihood of future violations, do not require proof of a past violation. See *United States v. W.T. Grant Co.*, 345 U.S. 629, 633 (1953). But see *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100 (2d Cir. 1972) (question is whether in light of past violations, there is a reasonable likelihood of repetition of the wrong).

issue of the appropriate burden of proof in terms of what a "proper showing" must be in SEC actions for injunctive relief.⁶⁷ In fact, most courts still have not yet decided this question.⁶⁸ The first court to address this issue was the Court of Appeals for the District of Columbia in *SEC v. Savoy Industries*.⁶⁹ In *Savoy*, the SEC sought an injunction against an individual for violations of the reporting requirements of the 1934 Act.⁷⁰ The court declared that the appropriate standard of proof in such actions was proof by a preponderance of the evidence.⁷¹ The defendant's proposal that the proper standard was a clear and convincing evidence standard⁷² was considered and rejected by the *Savoy* court.⁷³ In reaching that decision, the court briefly examined the factors that had led to the employment of the clear and convincing standard in SEC administrative proceedings for fraud.⁷⁴ According to the court, these factors included the quasi-criminal nature of the case and a deprivation of livelihood likely to result from the proposed sanctions.⁷⁵ The court noted, however, that injunctive relief suits were "qualitatively different" from such administrative proceedings.⁷⁶ This qualitative difference arose from the quasi-penal effects of administrative proceedings as compared with the solely remedial and preventative nature of injunctions.⁷⁷ Furthermore, the court found that an injunction against future violations of the reporting provisions was not likely to involve a deprivation of livelihood to the defendant.⁷⁸ As a result, the court concluded that a less strict, preponderance standard was the appropriate standard of proof.⁷⁹

⁶⁷ See *supra* note 5.

⁶⁸ Only two cases have involved the issue of the standard of proof for SEC injunctions to date. *SEC v. First Fin.*, 645 F.2d 429 (5th Cir. 1981) (standard of proof for SEC injunctions against fraud); *SEC v. Savoy Indus.*, 587 F.2d 1149 (D.C. Cir. 1978) (standard of proof for SEC injunctions against reporting violations).

⁶⁹ 587 F.2d 1149 (D.C. Cir. 1978).

⁷⁰ *Id.* at 1168 n.46. These violations were of §§ 13(d)(1, 3) of the 1934 Act, 15 U.S.C. § 78m(d)(1, 3) (1976), which require the filing of certain statements with the SEC.

⁷¹ 587 F.2d at 1169.

⁷² This standard was first proposed for use in SEC administrative proceedings in *Collins Sec. Corp. v. SEC*, 562 F.2d 820, 826 (D.C. Cir. 1977). The *Collins* case involved severe sanctions imposed by the SEC in an administrative proceeding against a registered broker-dealer for violations of various anti-fraud provisions. *Id.* at 821 n.2. The court ruled that the severe detriment to the defendant imposed by the sanctions (amounting to a deprivation of livelihood) and the circumstantial nature of the proof offered by the SEC warranted a standard of proof greater than a preponderance of the evidence. *Id.* at 826. *Collins* was essentially overturned by the United States Supreme Court in *Steadman v. SEC*, 450 U.S. 91 (1981). In *Steadman*, the Court held that § 7(c) of the Administrative Procedure Act, 5 U.S.C. § 556(d) (1976), prescribed a preponderance standard for SEC administrative proceedings. 450 U.S. at 102.

⁷³ 587 F.2d at 1168-69.

⁷⁴ *Id.*

⁷⁵ See *Collins Sec. Corp. v. SEC*, 562 F.2d 820, 826 (D.C. Cir. 1977).

⁷⁶ 587 F.2d at 1168.

⁷⁷ *Id.* For a discussion of how an injunction, while remedial in nature, may have severe collateral consequences, see *infra* notes 90-106 and accompanying text.

⁷⁸ 587 F.2d at 1169.

⁷⁹ *Id.*

In 1981, the Court of Appeals for the Fifth Circuit in *SEC v. First Financial Group of Texas*⁸⁰ extended the *Savoy* holding and ruled that the preponderance standard of proof should be employed in SEC civil enforcement actions requesting preliminary injunctive relief for violations of the anti-fraud provisions.⁸¹ The *First Financial* court's decision was based generally on the *Savoy* line of reasoning. First, the court applied the balancing of interests test developed in *Addington*⁸² to determine the allocation of the risk of error.⁸³ Then, the court summarily concluded that the defendant's interest in "avoiding the imposition of preliminary injunctive relief"⁸⁴ did not outweigh the "public interest in effective protection against future harm to the public from a defendant's fraudulent investment schemes."⁸⁵ Finally, the court reviewed the reasoning of the *Savoy* court concerning the severity of deprivation that the defendant was likely to suffer.⁸⁶ Agreeing with the reasoning of *Savoy*, the court held that First Financial's deprivation, the proscription on future securities violations, and its interest in avoiding such a proscription, were outweighed by the "significant public interest in effectively policing the securities industry and preventing future securities frauds shown to be reasonably likely."⁸⁷ According to the court, such a shift of the balance necessitated adherence to the preponderance of the evidence standard, particularly where preliminary injunctive relief, temporary by nature, was involved.⁸⁸

The *First Financial* court's analysis of the interests involved in the balancing test appears superficial. The court failed adequately to consider that an injunction might have effects beyond a proscription on the future commission of securities laws violations. Furthermore, the court did not comment on what made the public's interest in protection against future securities frauds so significant. In spite of the *First Financial* court's limited examination of the interests involved, the analysis and critique that follows will demonstrate that the court reached the correct conclusion. The appropriate standard of proof in SEC civil enforcement actions for injunctive relief in securities fraud cases should be a preponderance of the evidence.

III. ANALYSIS OF THE BALANCING TEST

It is unclear from the wording of the *First Financial* holding whether the Fifth Circuit intended the preponderance standard to apply only in SEC suits for preliminary injunctive relief.⁸⁹ It is now submitted, however, that the

⁸⁰ 645 F.2d 429 (5th Cir. 1981).

⁸¹ *Id.* at 435.

⁸² 441 U.S. 418, 425 (1979).

⁸³ 645 F.2d at 434-35.

⁸⁴ *Id.* at 434.

⁸⁵ *Id.*

⁸⁶ *Id.* at 435.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ See *supra* note 31 and accompanying text.

reasoning of *First Financial* is fully applicable to both permanent and temporary injunctions sought by the SEC. An analysis of the competing interests of the individual defendant and the investing public demonstrates that a preponderance standard appropriately allocates the risk of an erroneous decision in all SEC civil enforcement actions for injunctive relief. First, the defendant's interests in a securities fraud injunction suit will be outlined. In this connection, particular attention to the distinction between the direct and indirect results of an injunction is warranted. Next, the casenote will discuss the interest of the public in obtaining injunctions against securities fraud. In addition to the competing interests of the public and the defendant in a securities action, two other factors important to the balancing process are discussed. The first of these factors, involving the use of the clear and convincing standard in common law fraud actions, is enunciated within the context of the distinctions between securities fraud and common law fraud. The second factor considered involves a comparison between traditional equity injunctions and SEC injunctions. After describing the interests and factors involved, the interests of defendants in avoiding injunctions will be balanced against the public's interest in the enforcement of securities regulations. Finally, the outcome of this balancing will demonstrate the appropriateness of the preponderance standard for all SEC civil enforcement actions for injunctive relief.

On first impression, the individual's interest in avoiding the imposition of an injunction seems more substantial than was acknowledged in *First Financial*.⁹⁰ While it is well-established that the primary purpose of injunctive relief is "to deter future violations"⁹¹ and not to punish the violator,"⁹² the consequences of injunctions may be as severe as those of more punitive measures.⁹³ These consequences of an injunction may be direct or collateral. The direct result of an SEC injunction is a court order prohibiting violation of the federal securities laws in the future.⁹⁴ Failure to comply with this order can result in prosecution for criminal or civil contempt.⁹⁵ This contempt sanction

⁹⁰ As noted in the text *supra* at note 30, the *First Financial* court stated that the only deprivation to the defendant would be an inability to commit future securities violations. 645 F.2d at 435.

⁹¹ See, e.g., *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 n.6 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978). In *Lipper*, Judge Friendly stated: "the objective [of injunctive proceedings] . . . is solely to prevent threatened future harm"

⁹² *SEC v. Savoy Indus.*, 587 F.2d 1149, 1169 (D.C. Cir. 1978). The *Collins* court recognized that whereas actions by the SEC may be viewed as remedial by the public and the enforcement agency, they may be viewed as having punitive impact by the sanctioned individual. *Collins Sec. Corp. v. SEC*, 562 F.2d 820, 825 (D.C. Cir. 1977).

⁹³ In light of the serious detriment an injunction may impose, a defendant's interest in avoiding the injunction may be substantial. See *SEC v. Commonwealth Chem. Soc., Inc.*, 574 F.2d 90, 99 (2d Cir. 1978) ("An injunction while not always 'a drastic remedy' . . . often is much more than [a] 'mild prophylactic' . . .").

⁹⁴ See Note, *Injunctive Relief in SEC Civil Actions: The Scope of Judicial Discretion*, 10 COLUM. J. L. & SOC. PROBS. 328, 340 (1974).

⁹⁵ *Id.* at 340-41; see Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 946-50 (1971).

may issue even where there has been no "intent" to violate the securities laws.⁹⁶ These penalties, moreover, may be incurred without the benefit of an indictment or a jury trial.⁹⁷

In addition to the direct consequences of an injunction, there are collateral or indirect results. Some of these indirect consequences may follow an injunction whenever the SEC decides that such sanctions are within the best interests of the public. Some sanctions result from an independent proceeding conducted by the SEC after the issuance of an injunction. Other consequences follow the imposition of an injunction automatically by operation of law. For example, a Regulation A exemption from registration requirements for the issuance of securities is automatically unavailable to an enjoined party.⁹⁸ In addition, an injunction prevents the enjoined party from serving as a director, officer or employee of a registered investment company.⁹⁹ Most of the collateral consequences of an injunction, however, do not automatically issue. Based upon the imposition of an injunction, the SEC may, after notice and a hearing, impose other sanctions. An injunction may serve as the basis for suspension or revocation of a broker-dealer's registration or for prohibition of association with broker-dealers.¹⁰⁰ The SEC also can bar a permanently enjoined party from practice before the SEC.¹⁰¹

A further consequence of the issuance of an injunction is the adverse publicity that may accompany a fraud injunction. The SEC often requires that an injunction be disclosed in reports and information sent to shareholders and investors as well as in materials filed with regulatory agencies such as the

⁹⁶ See *United States v. Custer Channel Wing Corp.*, 247 F. Supp. 481, 490 (D. Md. 1965). In the *Custer Channel Wing* case, the court noted that proof of specific intent was not an essential element of criminal contempt. *Id.* Furthermore, although the United States Supreme Court has ruled that proof of scienter or intent was necessary to show certain securities fraud violations, it was not required for all violations. See *Aaron v. SEC*, 446 U.S. 680, 697 (1980) (scienter not required for violations of sections 17(a)(2) and 17(a)(3) of the 1933 Act). Therefore, a negligent violation of such provisions would qualify as contempt. See Note, *supra* note 94, at 343.

⁹⁷ *SEC v. Cenco, Inc.*, 436 F. Supp. 193, 198 (N.D. Ill. 1977) (quoting 3A H. BLOOM-ENTHAL, *SECURITIES AND FEDERAL CORP. LAW* 802[3], at 8-12 (1976)). See, e.g., *Gunn v. Univ. Committee to End the War in Viet Nam*, 399 U.S. 383, 389 (1970) (injunction enforceable by power of contempt).

⁹⁸ SEC Rule 252(c)(4) of Regulation A, 17 C.F.R. 230.252(c)(4) (1981). Regulation A exempts certain small public offerings of securities from registration.

⁹⁹ See § 9(a)(2) of the Investment Company Act of 1940, 15 U.S.C. § 80a-9-(a)(2) (1976).

¹⁰⁰ See § 15(b)(4)(C) of the 1934 Act, 15 U.S.C. § 78o(b)(4)(c) (1976).

¹⁰¹ SEC's Rules of Practice, Rule 2(e)(3)(i), 17 C.F.R. § 201.2(e)(3)(i) (1981). A bar from practice before the SEC means that one may not advise, counsel, or otherwise practice securities law in general. The application of this rule, particularly in relation to attorneys, has been the subject of debate. See *Touche Ross & Co. v. SEC*, 609 F.2d 570, 578-82 (2d Cir. 1979); see generally *Downing & Miller, The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979) (criticizing recent expansions in the use of Rule 2(e)); *Greenbaum, Client's Frauds and Their Lawyers' Obligations*, 68 GEO. L. J. 191 (1979) (discussing the duty imposed upon lawyers by the SEC's use of Rule 2(e)).

SEC.¹⁰² The institution of a suit and the final outcome are also publicly reported.¹⁰³ Moreover, the SEC may publicize any disciplinary proceedings it conducts or may even publish investigation reports regardless of whether the reports lead to criminal, civil or disciplinary actions by the agency.¹⁰⁴ These public disclosures may be particularly damaging when the connotations of dishonesty and disgrace accompanying violations of the securities anti-fraud provisions are considered.¹⁰⁵ In fact, many practitioners look upon the reputational damages resulting from an injunction as devastating to their position in the securities industry.¹⁰⁶ As a result of these consequences, it has been suggested that "a successful injunctive action . . . may deprive an individual of his livelihood."¹⁰⁷

Although the collateral consequences may, indeed, have a detrimental impact on the defendant, some of these consequences are the results of independent proceedings that carry their own standards of proof.¹⁰⁸ As noted above, the suspension and/or revocation of a broker-dealer's registration occurs only after an administrative proceeding.¹⁰⁹ At such a proceeding, the SEC still must show the need for such a sanction by a preponderance of the evidence.¹¹⁰ To bar an enjoined party from practice before the SEC also requires a separate hearing at which the SEC must show that the public interest requires such disqualification.¹¹¹ Thus, it seems inappropriate to consider the individual's interest in avoiding an injunction as equivalent to his interests in avoiding such independent sanctions.¹¹² Furthermore, upon application and

¹⁰² See SEC Rel. Nos. 33-5949, 34-15006, 35-20643, 1C-10342 (Sept. 30, 1978), 15 SEC Docket 428 (Aug. 15, 1978); Mathews, *SEC Civil Injunctive Actions*, 5 REV. SEC. REG. 969, 971 (1972).

¹⁰³ Mathews, *supra* note 102, at 976.

¹⁰⁴ See Note, *The Burden of Proof in SEC Disciplinary Proceedings: Preponderance and Beyond*, 49 FORDHAM L. REV. 642, 652-53 nn.52-54 (1981).

¹⁰⁵ See, e.g., *Ross v. A.H. Robbins*, 607 F.2d 545, 557 (2d Cir. 1979) (court noted harm to defendant's good will arising from charge of fraud); *Whitney v. SEC*, 604 F.2d 676, 680-81 (D.C. Cir. 1979) (court noted seriousness of potential anti-fraud sanction and consequent injury to reputation); *Gilbert v. Bagley*, 492 F. Supp. 714, 725 (M.D.N.C. 1980) (court noted reputational damage that may result from fraud allegations); *Rich v. Touche Ross & Co.*, 68 F.R.D. 243, 245 (S.D.N.Y. 1975) (court noted that reputational damage from fraud allegations particularly acute in certain professions).

¹⁰⁶ See Note, *supra* note 104, at 452 n.52.

¹⁰⁷ Berner and Franklin, *Scienter and SEC Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. REV. 769, 786 (1976).

¹⁰⁸ *SEC v. National Student Mktg.*, 457 F. Supp. 682, 701 n.43 (D.D.C. 1978).

¹⁰⁹ See *supra* text accompanying notes 99-100.

¹¹⁰ See, e.g., *Steadman v. SEC*, 450 U.S. 91 (1981) (preponderance standard required in SEC disciplinary proceedings).

¹¹¹ Note, *supra* note 94, at 342.

¹¹² In *National Student Mktg.*, *supra* note 108, a case involving an injunction against an attorney for aiding and abetting violations of the securities laws, the court distinguished the consequences of an injunction from the deprivations resulting from subsequent independent actions. 457 F. Supp. at 701 n.43.

after a hearing before the SEC, the automatic results of an injunction, namely the disqualification of the enjoined party from serving as a director, officer or employee of a registered investment company or from receiving a Regulation A exemption, may be waived or lifted.¹¹³ Thus, the unavoidable consequences to the individual defendant constitute his interest in avoiding an injunction. These consequences are an inability to commit future violations of the federal securities laws without risking a contempt charge if such violations occur, and any reputational damages arising from adverse publicity.

Balanced against the interest of the individual in avoiding an injunction is the public interest in protecting investors against fraudulent securities schemes.¹¹⁴ This public interest in protection was the aftermath of the disastrous 1929 stock market crash.¹¹⁵ In 1933 and 1934, Congress recognized that the old doctrine of caveat emptor was inapplicable to the securities industry due to the inherently unequal position of the investing public in comparison with that of the securities dealer.¹¹⁶ As a result, Congress incorporated into the 1933 and 1934 Acts a policy of full disclosure.¹¹⁷ In recognition that the crash was due in large part to widespread abuses and the abandonment of fair dealing by securities dealers,¹¹⁸ Congress also wanted to protect the investing

¹¹³ This waiver or lifting is made pursuant to Rule 252(f) under Regulation A, 17 C.F.R. 230.252 (1973) and § 9(c) of the Investment Company Act of 1940, 15 U.S.C. § 80a-9(c) (1970). See Mathews, *supra* note 102, at 970 nn.12-14; see, e.g., SEC v. Sun Oil Ins. [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97280 (S.D.N.Y. 1980) (SEC granted temporary waiver of disqualification).

¹¹⁴ 645 F.2d at 434.

¹¹⁵ The 1934 Senate Committee Report on Banking and Currency (the Pecora Committee Report) commented on the stock market collapse as follows:

The economic cost of this down-swing in security values cannot be accurately gauged. The wholesale closing of banks and other financial institutions; the loss of deposits and savings; the drastic curtailment of credit; the inability of debtors to meet their obligations; the growth of unemployment; the diminution of the purchasing power of the people to the point where industry and commerce were prostrated; and the increase in bankruptcy, poverty, and distress — all these conditions must be considered in some measure when the ultimate cost to the American public of speculating on the securities exchanges is computed.

Columbia Note, *supra* note 95 at 332 (quoting Senate Committee on Banking and Currency, Stock Exchange Practices, S. REP. NO. 1455, 73d Cong., 2d Sess. (1934)).

¹¹⁶ Newton, *The Limits of Liability: Recent Judicial Restrictions on Rule 10b-5*, 6 FLA. ST. U.L. REV. 63, 65 (1978).

¹¹⁷ *Id.*

¹¹⁸ A description of the abuses leading to the crash appears in H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933):

During the post war decade some 50 billion of new securities were floated in the United States. Fully half or 25 billion worth of securities floated during this period have been proven to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement in investment in any enterprise. Alluring promises of easy wealth were freely made with little or no at-

public by providing for the enforcement of a high standard of business ethics.¹¹⁹ It therefore provided specific bans on misleading, fraudulent and deceptive practices¹²⁰ and enacted enforcement provisions under the 1933 and 1934 Acts.¹²¹ The SEC was then created to enforce the 1933 and 1934 Acts.¹²² The SEC's most frequently employed scheme of enforcement is through civil enforcement actions for injunctive relief.¹²³ In addition to congressional recognition of this public interest, courts also have noted its importance. Weighing the desire of Congress to protect public investors¹²⁴ as well as the basic need for such protection, courts generally have found that protection of the investing public is a significant interest.¹²⁵ Some courts have gone further and held that because injunctions are designed to protect against future violations and because the necessity of such protection is significant, due to the harm that may result from such violations, the public interest usually takes precedence over the individual's interest.¹²⁶

tempt to bring to the investors' attention those facts essential to estimating the worth of any security.

Newton, *supra* note 116, at 64 n.6 (quoting H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933))

¹¹⁹ Newton, *supra* note 116, at 65.

¹²⁰ The 1933 and 1934 Acts contain three general anti-fraud provisions designed to protect the investing public: 17(a) of the 1933 Act (see *supra* note 18 for the text of this provision); 10(b) of the 1934 Act (see *supra* note 19 for the text of this provision) and Rule 10b-5 promulgated thereunder (see *supra* note 20 for the text of this rule); 15(c)(1) of the 1934 Act. Section 15(c)(1), 15 U.S.C. 78o(c)(1) provides:

(c)(1) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance, and no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

¹²¹ See, e.g., sections 15(b)(4), (6) of the 1934 Act, 15 U.S.C. §§ 78o(b)(4), (6) (1976) (provisions for administrative disciplinary proceedings); 1933 and 1934 Act sections cited *supra* at note 4.

¹²² See SEC v. Capital Gains Research Bureau, 375 U.S. 180, 181, 186 (1963).

¹²³ In 1980, the SEC instituted 74 administrative proceedings, 103 injunctive actions and referred 74 cases to the Justice Department for criminal proceedings. 46 SEC Ann. Rep. 141-42 (1980).

¹²⁴ Associated Sec. Corp. v. SEC, 283 F.2d 773, 775 (10th Cir. 1960).

¹²⁵ *Steadman v. SEC*, 603 F.2d 1126, 1139 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The *Steadman* court noted: "[t]he public interest in high standards of conduct in the securities business is a great one." *Id.* See, e.g., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1102 (2d Cir. 1972); SEC v. Culpepper, 270 F.2d 241, 250 (2d Cir. 1959).

¹²⁶ See, e.g., SEC v. Advance Growth Capital Corp., 470 F.2d 40, 53 (7th Cir. 1972); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1102 (2d Cir. 1972); SEC v. Culpepper, 270 F.2d 241, 250 (2d Cir. 1959). *But cf.* Reich, *The Law of the Planned Society*, 75 YALE L. J. 1227, 1234-35, 1238-40 (1966) (discussing the inadequacy of the "public interest" standard); Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1712 (1975) (there is no

In balancing the individual and public interests at stake, two other factors may be considered in the determination of the appropriate standard of proof for SEC injunctions. First, it may be argued that because a clear and convincing standard is employed in common law fraud cases,¹²⁷ the same standard should be used for securities fraud. Such a proposition fails to consider that securities fraud is a different type of action than common law fraud. Securities fraud was designed to encompass a broader range of conduct than the conduct actionable under common law for civil fraud.¹²⁸ Furthermore, at the time of the enactment of the 1933 and 1934 Acts, there were two types of remedies for misrepresentation or fraud under the common law. Actions for equitable relief had a lower burden of proof than action for damages.¹²⁹ This lower burden was due to the different nature of the remedies. Equitable relief, particularly injunctive relief, serves basically to prevent future violations rather than to punish the violator.¹³⁰ In contrast, the legal remedies for common law fraud "center about redress, vindication, punishment, [and] restitution."¹³¹ Thus, a civil fraud action for damages may subject an individual defendant to a potentially greater liability than is usually found in an equitable action.¹³² Under the federal securities laws, Congress created only an equitable action for enforcement of the anti-fraud provisions.¹³³ Although the courts may order ancillary

definable public interest but only competing individual and group interests). The court in *SEC v. Decker* stated: "personal injury 'is not of controlling importance as primary consideration must be given to the statutory intent to protect investors.'" 631 F.2d 1380, 1384 (10th Cir. 1980) (quoting *Associated Sec. Corp. v. SEC*, 283 F.2d 773, 775 (10th Cir. 1960)).

¹²⁷ See *supra* note 51 for civil fraud cases using clear and convincing standard.

¹²⁸ Common law fraud is generally distinguished from securities fraud. *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 847 (E.D. Va. 1968) (churning is fraud in law, different from common law fraud); *LOSS, supra* note 66, at 1435. Although the exact reason for this distinction is unknown, it is possibly due to a recognition by Congress that common law fraud was an insufficient deterrent to abuse in the securities area as illustrated by the 1929 stock market crash. As a result of the crash, Congress did establish the broader concept of securities fraud in the 1933 and 1934 Acts. *Newton, supra* note 116, at 64. This broader concept apparently was designed to be flexible enough to protect the investing public from "a certain class of gentleman [who] . . . would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law." *LOSS, supra* note 66, at 1436 (quoting *State v. Whiteaker*, 118 Or. 656, 661, 247 P. 1077, 1079 (1926)). As the result of this concern, securities fraud includes by definition conduct that would not be actionable at common law. For example, the SEC may enjoin a party who is "about to engage" in violations of the securities regulations. See section 20(b) of the 1933 Act cited *supra* at note 4. In addition, intent is not required for certain types of securities fraud. See *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

¹²⁹ Casenote, *A Scienter Requirement for SEC Injunctions Under Section 10(b) — Investor Protection Under the Securities Laws is Further Restricted: Aaron v. SEC*, 22 B.C.L. REV. 595, 618 (1981).

¹³⁰ *Hecht Co. v. Bowles*, 321 U.S. 321, 329 (1944).

¹³¹ F. LAWRENCE, *SUBSTANTIVE LAW OF EQUITY JURISPRUDENCE* 13 (1929).

¹³² *Schulman, Civil Liability and the Securities Act*, 43 YALE L. J. 227, 233 (1933).

¹³³ Section 21(e) of the 1934 Act. See *supra* note 4 for the text of this provision. Although no private right of action for securities fraud was explicitly created by Congress in the securities laws, such a right has been recognized by courts as implied under Section 10(b) of the 1934 Act. See *Supt. of Ins. v. Bankers L. & C. Co.*, 404 U.S. 6, 13 n.9 (1971). These private actions may be brought to obtain damages as well as equitable relief. See, e.g., *Harris v. American Investment Co.*, 523 F.2d 220, 224-25 (8th Cir. 1975) (out-of-pocket damages awarded to private litigant);

relief¹³⁴ under general equitable principles in addition to or in lieu of injunctive relief, this relief also is remedial rather than punitive.¹³⁵ Ancillary relief has included orders for disgorgement or return of profits, appointment of a receiver to protect and preserve assets, appointment of independent members to the board of directors and appointment of a special counsel.¹³⁶ The purpose of such ancillary relief is to restore the injured party to the state he was in prior to the violation and to prevent the occurrence of additional harm.¹³⁷

The second factor which may be influential in the determination of the appropriate standard of proof in SEC injunctive suits involves a comparison of traditional equity injunctions and SEC injunctions. SEC actions for injunctive relief differ from traditional actions for injunctive relief in that the SEC need not show all of the elements usually required to obtain a preliminary injunction.¹³⁸ In traditional actions, these elements include a showing that the plaintiff has no adequate remedy at law,¹³⁹ that he will be irreparably harmed if the injunction does not issue,¹⁴⁰ that the harm to the defendant imposed by the injunction is less than the harm the plaintiff would suffer without the injunction (the balance of hardships),¹⁴¹ that granting the injunction is not against public interest,¹⁴² and that the plaintiff is reasonably likely to succeed on the merits.¹⁴³ The courts, however, have decided that the SEC need not show all of these elements. A showing by the SEC of irreparable harm to an individual or market is not required by most courts.¹⁴⁴ The SEC need not show a favorable

Gordon v. Burr, 506 F.2d 1080, 1083 (2d Cir. 1974) (rescission ordered); Ruckle v. Roto American Corp., 339 F.2d 24, 28 (2d Cir. 1964) (preliminary injunction permitted). See also LOSS, *supra* note 66, at 1795-96; Note, *Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371 (1974).

¹³⁴ Ancillary relief is equitable relief other than injunctive relief. See SEC v. Pennsylvania Cent. Co., 425 F. Supp. 593, 598-99 (E.D. Pa. 1976); see generally Jacobs, *Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5*, 53 ST. JOHN'S L. REV. 397, 410, 413 (1979) (discussing ancillary relief in SEC actions for breach of Rule 10b-5).

¹³⁵ SEC v. American Inst. Counselors, Inc., [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,388, at 98,964 (D.D.C. 1975).

¹³⁶ See, e.g., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (disgorgement); SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 42 (S.D.N.Y. 1968) (receiver appointed), *aff'd*, 435 F.2d 510 (2d Cir. 1971); see generally Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976) (examining the imposition of ancillary relief in SEC enforcement actions) for cases cited therein.

¹³⁷ See Jacobs, *supra* note 134, at 412.

¹³⁸ *Id.* at 401-02; see Note, *supra* note 94, at 336. This lesser burden may be due to the statutory nature of SEC injunctions. One commentator has stated that "[s]ince SEC injunctions are creatures of statute, all that must be established is what the statute requires, without reference to proof of irreparable injury or the inadequacy of other remedies, as in the usual suit for injunction." LOSS, *supra* note 66, at 1979.

¹³⁹ See, e.g., American Dairy Queen Corp. v. Brown-Port Co., 621 F.2d 255, 257 (7th Cir. 1980); Carlson Co. v. Sperry & Hutchinson Co., 374 F. Supp. 1080, 1097 (D. Minn. 1974); 7 J. MOORE, FEDERAL PRACTICE 65-39 to -45 (2d ed. 1974).

¹⁴⁰ See *id.*

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ See, e.g., SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975)

tipping of the balance of hardships,¹⁴⁵ nor is it required to show the inadequacy of other remedies.¹⁴⁶ Generally, the SEC must make a "proper showing" that there is a reasonable likelihood that the defendant is engaged in or is about to engage in practices that violate the federal securities laws.¹⁴⁷

In determining whether the SEC has met its burden of a "proper showing," the court considers several factors prior to the issuance of an injunction.¹⁴⁸ These may include: "the egregiousness of the [violations], the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the [violinator's] assurances against future violations, the [violinator's] recognition of the wrongful nature of his conduct, and the likelihood that [his] occupation will present opportunities for future violations."¹⁴⁹ Some courts also have considered the time elapsed between the violations and the court's decision,¹⁵⁰ whether the violator relied in good faith on advice of counsel,¹⁵¹ and the adverse effect of an injunction upon the defendant.¹⁵² The consideration of these factors indicates that an injunction does not automatically issue upon a finding of a past violation of the federal securities laws.¹⁵³

The interests and comparison factors outlined above may now be weighed in an *Addington*-type balancing test to determine the appropriate standard of proof for SEC anti-fraud injunctions. On one side is the defendant's interest in avoiding an injunction. This interest is comprised essentially of an inability to commit future violations of the securities laws without risking civil or criminal contempt charges if such violations occur.¹⁵⁴ Also included is possible reputational damage from adverse publicity.¹⁵⁵ In addition, such factors as the re-

(showing of irreparable injury and inadequate remedy at law not required); SEC v. Parklane Hosiery Co., 422 F. Supp. 477, 486 (S.D.N.Y. 1976) (showing of irreparable harm not required), *aff'd*, 558 F.2d 1083 (2d Cir. 1977); SEC v. Scott, Gorman Muns., Inc., 407 F. Supp. 1383, 1387 (S.D.N.Y. 1975) (proof of irreparable injury not required); SEC v. J & B Indus., Inc., 388 F. Supp. 1082, 1084 (D. Mass. 1974) (requirement of proof of irreparable injury inapplicable). *But see* SEC v. Senex Corp., 399 F. Supp. 497, 508 (E.D. Ky. 1975) (showing of irreparable injury required), *aff'd*, 534 F.2d 1240, 1241 (6th Cir. 1976); SEC v. Petersen [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,254 at 98,319 (D. Minn. 1975) (showing of imminent threatened harm required). The SEC usually alleges irreparable injury to avoid the issue of non-compliance with Rule 65(b) of the Federal Rules of Civil Procedure. LOSS, *supra* note 66, at 1980.

¹⁴⁵ See SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975).

¹⁴⁶ SEC v. Jet Travel Services, Inc. [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,317 at 98,608 (M.D. Fla. 1976).

¹⁴⁷ See *supra* note 66.

¹⁴⁸ See Jacobs, *supra* note 134, at 403.

¹⁴⁹ SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978), *quoted in* Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

¹⁵⁰ See, e.g., SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 716 (D.D.C. 1978).

¹⁵¹ See SEC v. Lum's, Inc., 365 F. Supp. 1046, 1066 (S.D.N.Y. 1973).

¹⁵² See SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1102 (2d Cir. 1972).

¹⁵³ See, e.g., SEC v. Caternicchia, 613 F.2d 102, 103 (5th Cir. 1980); SEC v. Monarch Fund, 608 F.2d 938, 943 (2d Cir. 1979).

¹⁵⁴ See *supra* notes 90-97 and accompanying text.

¹⁵⁵ See *supra* notes 103-06 and accompanying text.

quirement of a clear and convincing standard of proof for common law fraud and the courts' determination that the SEC need not show all of the elements required for a traditional injunction¹⁵⁶ may suggest that the defendant's side of the balance is important enough to warrant a shift in the allocation of the risk of erroneous decision away from the defendant. On the opposite side of the balancing test, weighed against these factors and the defendant's interest in avoiding an injunction, is the public interest in protection against the perpetration of securities fraud.¹⁵⁷ This interest has been recognized as very important by both Congress and the courts.¹⁵⁸ Indeed, Congress created the SEC to enforce, by equitable means, the protection provided in the 1933 and 1934 Acts.¹⁵⁹ In cooperation with the congressional intent to protect the investing public, the courts have traditionally held that the public interest takes precedence over individual interests in SEC equitable actions.¹⁶⁰

In providing only for such equitable enforcement actions as suits for injunctive relief, Congress appears to have followed the then-existing structure of the equitable suit for misrepresentation or fraud with the lower burden of proof required.¹⁶¹ To require now an increase in the standard of proof for SEC injunctions would put such actions on the same evidentiary footing as civil fraud cases for damages, a result Congress clearly did not intend.¹⁶² In addition to carrying out the congressional intent favoring a low burden of proof for injunctions against fraudulent practices in the securities industry, three other reasons for maintaining such a low burden exist. First, the functions of private damage suits and SEC injunctive actions are quite different. Private damage suits usually seek to make an injured individual "whole"¹⁶³ whereas SEC injunctive actions seek to protect the investing public by preventing future violations of the federal securities laws.¹⁶⁴ This difference in function is additional support for applying different standards of proof in civil fraud actions and SEC anti-fraud injunctive actions.

Second, although the SEC need not show *all* of the traditional elements for preliminary injunctions, the factors the courts consider prior to the issuance of an injunction¹⁶⁵ adequately protect the individual's interest. In situations where the defendant has blatantly, repeatedly and egregiously violated the federal securities laws, such factors will weigh heavily against the defendant.¹⁶⁶

¹⁵⁶ See *supra* notes 138-47 and accompanying text.

¹⁵⁷ See *supra* note 114 and accompanying text.

¹⁵⁸ See *supra* notes 115-26 and accompanying text.

¹⁵⁹ See *supra* note 122 and accompanying text.

¹⁶⁰ See cases cited *supra* note 126.

¹⁶¹ See Casenote, *supra* note 129, at 618-19; see also *supra* note 132.

¹⁶² See *Hecht v. Bowles*, 321 U.S. 321 (1944) ("It is therefore even more compelling to conclude that, if Congress desired to make such an abrupt departure from traditional equity practice as is suggested, it would have made its desire plain").

¹⁶³ W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 1 at 2, § 2 at 9 (4th ed. 1971).

¹⁶⁴ See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 201 (1963).

¹⁶⁵ See *supra* notes 148-53 and accompanying text.

¹⁶⁶ See Note, *supra* note 94, at 343.

So, also, in the case where the violation has been relatively minor and the effects of an injunction upon the defendant are severe, the court may use its wide discretionary authority in determining whether an injunction should issue.¹⁶⁷ This power of discretion has not been exercised frivolously by the courts.¹⁶⁸ For example, the SEC has frequently been denied injunctive relief upon a failure to make a proper showing of a reasonable likelihood of future occurrences of securities fraud.¹⁶⁹

Finally, because the public's interest in protection is so significant, the low preponderance standard of proof avoids needlessly hindering the SEC's ability to police the securities industry.¹⁷⁰ These enforcement powers of the SEC were deliberately designed by Congress to be broad and flexible enough to achieve regulation of the very sensitive securities industry.¹⁷¹ Courts, however, have not allowed the SEC to operate in an unchecked fashion, despite a recognition of the importance of the public interest in the effective enforcement of the federal securities laws. Indeed, recent court decisions have increased the SEC's burden in ways other than by increasing the standard of proof. For example, a showing of scienter is now required to enjoin violations under certain anti-fraud provisions.¹⁷² In addition, the availability of private actions under the securities laws has been curtailed,¹⁷³ thereby increasing the number of cases left to SEC enforcement of the securities laws. To add further to the SEC's burden by increasing the standard of proof could seriously endanger its ability to protect the public adequately. The resulting decrease in efficiency would thus frustrate the policies of investor protection and the encouragement of high business ethics behind the enactment of the securities laws.¹⁷⁴

In summary, the interests of the defendant in avoiding the imposition of an injunction, although not insignificant, are outweighed by the paramount interest of the public in protection against securities fraud. Moreover, the use of a clear and convincing standard of proof is not warranted for securities injunctive

¹⁶⁷ *E.g.*, SEC v. Arco Industries [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,921 (S.D.N.Y. 1971); see Note, *supra* note 94, at 353.

¹⁶⁸ See Steinberg, *SEC and Other Permanent Injunctions — Standards for their Imposition, Modification and Dissolution*, 66 CORNELL L. REV. 31, 38-39 (1980).

¹⁶⁹ See, *e.g.*, SEC v. Dimensional Entertainment Corp. [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,578 at 98,054-55 (S.D.N.Y. July 16, 1980); SEC v. Miller [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,551 at 97,890-91 (S.D.N.Y. June 27, 1980); see cases cited *supra* at note 153.

¹⁷⁰ See *Steadman v. SEC*, 603 F.2d 1126, 1139 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981) (if burden is too high, policing ability of SEC is impaired).

¹⁷¹ See Note, *supra* note 94, at 335.

¹⁷² *Aaron v. SEC*, 446 U.S. 680, 701 (1980).

¹⁷³ See, *e.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975) (10b-5 protection only for purchasers or sellers of securities); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472-75 (1977) (mere breach of fiduciary duty insufficient under 10b-5).

¹⁷⁴ Increasing the standard of proof might also have the effect of discouraging the injunctive action in federal court and encouraging resort to administrative proceedings. While this would lessen the burden of cases in the district court, it might also lessen the availability of a completely impartial proceeding.

actions despite the standard's employment in common law fraud cases. The two actions are significantly different in their ultimate goals. Nor is the imposition of an increased standard of proof justified by the fact that the SEC need not demonstrate all of the elements required for traditional equity injunctions. Adequate procedural safeguards exist in the discretion of the court to consider several factors prior to issuance of a securities injunction. Finally, an increased burden of proof would have the effect of hampering the police function of the SEC and thus lessening its ability to protect the public against securities fraud.

CONCLUSION

The court's holding in *S.E.C. v. First Financial Group of Texas* that the appropriate standard of proof in SEC civil enforcement actions for injunctive relief is a preponderance of the evidence standard should be extended to both permanent and preliminary injunctions sought by the SEC for violations of the anti-fraud provisions. Application of the *Addington* balancing of interests test supports this conclusion. The defendant's interest in avoiding an inability to commit future violations at the risk of a contempt charge and the risk of possible reputational damage is outweighed by the public's interest in protection against future securities violations. Furthermore, because securities fraud is a broader concept than common law fraud and the actions for common law fraud and securities fraud differ significantly in their functions, the standard of clear and convincing evidence applied in actions for common law fraud need not be employed in securities fraud injunctive actions. In addition, adequate protection for the individual defendant's interest is available through the court's exercise of its discretion in the consideration of several mitigating factors. Therefore, the best allocation of the risk of erroneous decision is that of the preponderance standard. Under this standard, the defendant and the SEC share equally the risk and the chance of a favorable decision. An equal allocation preserves the SEC's ability to police the securities industry and permits it to retain the flexibility of enforcement envisioned by Congress when it created the SEC.

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