

A Scienter Requirement for SEC Injunctions Under Section 10(b) — Investor Protection Under the Securities Laws is Further Restricted: *Aaron v. SEC*¹ — In *Ernst & Ernst v. Hochfelder*,² the Supreme Court resolved a conflict in the lower courts³ by holding that proof of scienter was required in private damage actions brought under section 10(b) of the Securities Exchange Act of 1934 (1934 Act)⁴ and rule 10b-5⁵ thereunder.⁶ The *Hochfelder* decision expressly reserved the issue whether a similar standard should apply to injunctive actions brought by the Securities and Exchange Commission (SEC or Commission) to enforce the provisions of section 10(b) and rule 10b-5.⁷ The *Hochfelder* Court's

¹ 446 U.S. 680 (1980).

² 425 U.S. 185 (1976).

³ 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, 569-70 & nn.5-13 (1977).

⁴ See note 11 *infra* for the text of § 10(b).

⁵ See note 12 *infra* for the text of rule 10b-5.

⁶ 425 U.S. at 193. The concept of scienter has proved elusive. The term has been defined to mean everything from knowing falsity to varying degrees of recklessness to such non-action as would be equivalent to negligence or even liability without fault. 3 L. LOSS, *SECURITIES REGULATION* 1432 (2d ed. 1961) [hereinafter cited as LOSS]. Professor Bromberg has gone so far as to suggest "[p]robably the most important step toward clarifying the law of scienter would be to ban the word." 3 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 8.4 (503), at 204.103 (1979).

Hochfelder did little to clarify the kind of conduct covered by its use of the term scienter. The opinion makes clear only that a cause of action may not be predicated on negligent conduct. 425 U.S. at 214. Whether scienter encompasses reckless or knowing deception, or is limited to intentional conduct, however, is not resolved by *Hochfelder*. In a footnote to its holding, the Court stated, "[i]n this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12. This definition of scienter would limit its scope to intentional conduct. At the same time, however, the court stated that the operative terms of § 10(b) "strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." *Id.* at 197. Under this construction, the scope of scienter is broadened to include knowing as well as intentional deception. In addition, the Court refused to decide whether "scienter" encompassed reckless conduct. *Id.* at 193 n.12. To include recklessness within the scope of scienter would broaden the ambit of § 10(b) even further.

⁷ 425 U.S. at 194 n.12. Commission injunctive actions are expressly authorized by § 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), and § 21(d) of the 1934 Act, 15 U.S.C. § 78u(d) (1976).

Private damage actions under § 10(b), however, are not expressly authorized by statute, but rather have been judicially implied. See, e.g., *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946) (first decision to imply the private cause of action). The language of § 10(b) makes no mention of a private cause of action for damages. See note 10 *infra*. Similarly, the legislative history evinces "no indication . . . that Congress thought it was creating private rights [in § 10(b)]." 1 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD*, § 2.2 (333), at 2.23-2.24 (1979). See generally Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 642-60 (1963); Note, *Implied Liability Under the Securities Exchange Act*, 61 HARV. L. REV. 858, 861 (1948). Similarly, there is no indication that the Commission in adopting rule 10b-5 intended to create private civil remedies under this provision. See SEC Release No. 3230 (May 21, 1942), 7 Fed. Reg. 3804 (1942). See also *Conference on the Codification of the Securities Laws*, 22 BUS. LAW. 793, 922 (1967); *Hochfelder*, 425 U.S. at 213 n.32.

Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), was the first decision to imply a private right of action under § 10(b). *Id.* at 513-14. Thereafter, the existence of a private damage action under the section has been accepted by all courts of appeals. The Supreme Court, however, has never squarely held that a private cause of action exists under § 10(b). *Aaron v. SEC*,

analysis of section 10(b) and its insistence that "the language of the statute controls" suggested that proof of scienter would also be required in Commission injunctive actions to enforce that provision.⁸ Analysis of the common law remedies for fraud, and considerations of the policy and statutory scheme of the federal securities acts, however, led many courts and commentators to reject a scienter requirement for SEC injunctions.⁹

*Aaron v. SEC*¹⁰ ended a lively dispute over the degree of culpability necessary for an injunction to issue for violations of section 10(b). In an opinion written by Justice Stewart, the Supreme Court held that the SEC must establish scienter to enjoin violations of section 10(b) of the 1934 Act¹¹ and rule 10b-5¹²

446 U.S. 680, 689 (1980) ("[T]his court has repeatedly assumed the existence of an implied cause of action under § 10(b) and rule 10b-5.") (emphasis added).

⁸ 425 U.S. at 197-201, 214 n.33.

⁹ After *Hochfelder*, courts of appeals divided on the issue of whether scienter was required in SEC injunctive actions. Compare *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978) (holding that scienter was required) with *SEC v. Aaron*, 605 F.2d 612 (2d Cir. 1979) and *SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976) (holding that scienter was not required). Commentators were equally divided on the issue after *Hochfelder*. Compare *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 (1977); *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); *Lowenfels, Scienter or Negligence Required for SEC Injunctions under Section 10(b) and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978); *Note, The Reach of the SEC Under Rule 10b-5 is Further Restricted: Negligent Conduct is Insufficient to Warrant Commission Instigated Injunctive Relief*, 31 U. MIAMI L. REV. 1524 (1977); *Note, New Light on an Old Debate: Negligence v. Scienter in an SEC Fraud Injunctive Suit*, 51 ST. JOHN'S L. REV. 759 (1977) (all arguing that scienter should be required in Commission injunctive actions under § 10(b) and rule 10b-5) with *Note, Securities Regulation — Courts Disagree Whether SEC Must Allege and Prove Scienter in Injunctive Actions Under Section 10(b) and Rule 10b-5*, 30 VAND. L. REV. 282 (1977); *Comment, Scienter as an Element in SEC Enforcement Actions*, 82 DICK L. REV. 121 (1977); *Note, Scienter's Scope and Application in Rule 10b-5 Actions: An Analysis in Light of Hochfelder*, 52 NOTRE DAME LAW. 925 (1977); *Note, Scienter and Injunctive Relief Under Rule 10b-5*, 11 GA. L. REV. 879 (1977); *Note, The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder*, 77 COLUM. L. REV. 419 (1977); *Note, Federal Securities Regulation — Beyond Hochfelder: Is There a Scienter Requirement in SEC Suits for Injunctive Relief?*, 22 VILL. L. REV. 1238 (1977); *Note, SEC Injunctive Actions: A Negligence Standard Under Rule 10b-5*, 28 SYRACUSE L. REV. 763 (1977); *Note, SEC Injunctive and Ancillary Relief Under Rule 10b-5: A Scienter Requirement?*, 1977 U. ILL. L.F. 872; and *Securities Law: The Scienter Requirement In An SEC Enforcement Action — Should Equity Control? — SEC v. Aaron*, 5 U. DAY. L. REV. 217 (1980) (all arguing that scienter is not required).

¹⁰ 446 U.S. 680 (1980).

¹¹ 15 U.S.C. § 78j(b) (1976). Section 10(b) applies to both buyers and sellers and provides in pertinent part:

It shall be unlawful for any person directly or indirectly, by 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.

Id.

¹² 17 C.F.R. § 240.10b-5 (1979). Rule 10b-5 was promulgated by the Securities and Exchange Commission in 1942. The rule provides:

It shall be unlawful for any person, directly or indirectly, by use of any means or

thereunder.¹³ The Court also ruled on the state of mind requirements for violations of section 17(a) of the Securities Act of 1933 (1933 Act).¹⁴ The proscriptions of section 17(a) apply only to deceptive practices in the offer or sale of securities, whereas section 10(b) and rule 10b-5 prohibit deceptive practices in either the purchase or sale of securities.¹⁵ The Court held that section 17(a)(1) requires proof of scienter when enforced by SEC injunctions, but that section 17(a)(2) and 17(a)(3) do not require proof of scienter.¹⁶

The defendant in *Aaron* was a managerial employee at E. L. Aaron & Company (the firm), a registered broker-dealer¹⁷ in securities.¹⁸ Between November 1974 and September 1975, two registered representatives of the firm who were under Aaron's supervision conducted a sales campaign in which they repeatedly made false and misleading statements while soliciting orders for the purchase of common stock in Lawn-A-Mat Chemical & Equipment Corporation (Lawn-A-Mat).¹⁹ During the course of this promotion, the representatives told potential investors that Lawn-A-Mat had plans to manufacture certain new lawn-care products.²⁰ Lawn-A-Mat, however, had no such plans.²¹ The representatives also made projections of substantial increases in the price of Lawn-A-Mat common stock and optimistic statements concerning the company's financial

instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

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

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

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

Id.

¹³ 446 U.S. at 701-02.

¹⁴ 15 U.S.C. § 77q(a) (1976). Section 17(a) applies only to sellers and provides: 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

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

Id.

¹⁵ Compare § 17(a), note 14 *supra*, with § 10(b), note 11 *supra*, and rule 10b-5, note 12 *supra*.

¹⁶ 446 U.S. at 701-02.

¹⁷ Broker-dealer: "A securities brokerage firm, usually registered with the S.E.C. and with the State in which it does business, engaging in the business of buying and selling securities to or for customers." BLACK'S LAW DICTIONARY 175 (5th ed. 1979).

¹⁸ 446 U.S. at 682.

¹⁹ *Id.* Lawn-A-Mat was engaged in the business of selling lawn-care franchises and supplying its franchises with products and equipment. *Id.*

²⁰ *Id.* Aaron & Co.'s registered representatives informed prospective investors that Lawn-A-Mat was planning or in the process of manufacturing a new type of small car and tractor, and that the car would be marketed within six weeks. *Id.*

²¹ *Id.*

condition.²² Lawn-A-Mat, however, was losing money during the relevant period.²³ Although counsel for Lawn-A-Mat informed Aaron that his representatives were making false and misleading statements,²⁴ the defendant took no affirmative steps to prevent the recurrence of such misrepresentations.²⁵ Aaron's only response was to inform one of the two representatives of Lawn-A-Mat's complaint and to direct him to communicate directly with counsel for Lawn-A-Mat.²⁶ Otherwise, defendant Aaron did nothing to prevent the two registered representatives under his direct supervision from continuing to make false and misleading statements while promoting Lawn-A-Mat common stock.²⁷

The Securities and Exchange Commission brought an enforcement action in the United States District Court for the Southern District of New York to enjoin Aaron and his representatives from continuing these deceptive practices in connection with the offer and sale of Lawn-A-Mat securities.²⁸ The Commission charged Aaron with violating and with aiding and abetting violations of three provisions of the securities laws: section 17(a) of the 1933 Act, section 10(b) of the 1934 Act, and rule 10b-5.²⁹ The Commission alleged that Aaron had

²² *Id.* at 682-83.

²³ *Id.* at 683.

²⁴ *Id.* Milton Kean, an attorney representing Lawn-A-Mat, communicated to Aaron by telephone on two occasions the substance of the inaccurate statements made by Aaron's representatives. *Id.* Aaron, in addition to being so informed by Kean, had reason to know of the falsity of the statements. His responsibility for maintaining the firm's due diligence files should have indicated a deteriorating financial condition and revealed no plans for manufacturing a new car and tractor. *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* The SEC filed a complaint in the district court against Aaron and seven other defendants for deceptive conduct in connection with the offer and sale of Lawn-A-Mat common stock. *Id.* Before commencement of the trial, all defendants in the action except Aaron consented to the entry of permanent injunctions against them. *Id.* at 684.

The Securities and Exchange Commission is authorized by § 20(b) of the 1933 Act to bring injunctive actions to enforce the statute and rules promulgated thereunder, 15 U.S.C. § 77t(b) (1976). Section 20(b) provides:

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., § 17(a),] or of any rule or regulation prescribed under the 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. *Id.* Similarly, § 21(d) of the 1934 Act, 15 U.S.C. § 78u(d) (1976), authorizes the Commission to seek injunctive relief whenever it appears that a person "is engaged or is about to engage in acts or practices constituting" a violation of the provisions of the 1934 Act (e.g., § 10(b)), or regulations promulgated thereto (e.g., rule 10b-5), and requires a district court "upon a proper showing" to grant injunctive relief. *Id.*

²⁹ 446 U.S. at 683-84. The Commission also charged Aaron and three other defendants with violating and aiding and abetting violations of the registration provisions of sections 5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§ 77e(a) and 77e(c) (1976), in connection with the offer and sale of Lawn-A-Mat stock. *Id.* at 684 n.1. The district court found that Aaron had violated these provisions and enjoined him from future violations. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043, at 91,686-87 (S.D.N.Y. 1977). The court of appeals affirmed this holding, 605 F.2d 612, 617-19 (2d Cir. 1979), and petitioner Aaron did not challenge this portion of the court of appeals' decision. 446 U.S. at 684 n.1.

actual or constructive knowledge that the employees under his supervision were engaged in fraudulent practices, but failed to take adequate steps to prevent those practices from continuing.³⁰

The district court found that Aaron had violated and aided and abetted violations of section 17(a), section 10(b), and rule 10b-5 during the Lawn-A-Mat sales campaign and enjoined him from future violations of these provisions.³¹ On the issue of the proper standard for liability in Commission enforcement proceedings under these provisions, the district court concluded that while a showing of negligence alone might suffice,³² Aaron's intentional failure to prevent his representatives from making false and misleading statements, while knowing such statements to be fraudulent, was sufficient to establish his scienter under the securities laws.³³

The Court of Appeals for the Second Circuit upheld the district court's grant of a permanent injunction against Aaron.³⁴ In so ruling, the circuit court addressed the issue of whether proof of scienter is a necessary element of a Commission enforcement action to enjoin violations of section 10(b) of the 1934 Act or of section 17(a) of the 1933 Act.³⁵ With regard to section 10(b), the court of appeals found it unnecessary to review the determination of the district court that Aaron's conduct supported a finding of scienter.³⁶ Instead, the court concluded the scienter requirement of *Hochfelder* was not applicable to SEC injunctive actions and held that the SEC need only show proof of negligence to enjoin violations of section 10(b).³⁷ The circuit court noted that its previous decisions had anticipated *Hochfelder* in holding that scienter was required in private damage actions under section 10(b).³⁸ At the same time, however, the Second Circuit had also consistently held that section 10(b) does not require proof of scienter when enforced by Commission injunctions.³⁹ This distinction was premised on the different purposes and policies of the two types of civil enforcement suits under section 10(b).⁴⁰ Whereas actions for damages are

³⁰ *Id.* at 684.

³¹ [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,043, at 91,685, 91,686-87. An injunction was issued even though the firm had gone bankrupt and Aaron was no longer working for a broker-dealer. The district court stated that the standard governing the issuance of an injunction in Commission enforcement actions is whether there is a reasonable likelihood that the violations will be repeated. *Id.* at 91,686. The court reasoned that since Aaron was currently working in the related field of commodities trading and had expressed at trial a strong interest in returning to the securities industry, a likelihood of future violations was present. *Id.* The court concluded that the "nature and extent of the violations . . . [and the petitioner's] failure to recognize the wrongful nature of his conduct" warranted injunctive relief. *Id.* at 91,686-87.

³² *Id.* at 91,685.

³³ *Id.*

³⁴ SEC v. Aaron, 605 F.2d 612, 624 (2d Cir. 1979).

³⁵ *Id.* at 619.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at 620. See, e.g., Lanza v. Drexel, 479 F.2d 1277, 1304-06 (2d Cir. 1973) (en banc); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971).

³⁹ 605 F.2d at 620-21.

⁴⁰ *Id.* at 621. The court of appeals did not explain the policy considerations underlying the federal securities act upon which it relied, but cited as supporting authority SEC v. Spectrum, Ltd., 489 F.2d 535, 541-42 (2d Cir. 1973) ("In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due

designed to provide compensation for individual investors, suits for injunctive relief serve to provide maximum protection for the investing public.⁴¹ In accordance with its view of the protective, rather than punitive, function of Commission injunctions,⁴² the court concluded that the increased effectiveness of Commission enforcement actions under a negligence standard outweighed the danger of potential harm to those enjoined from violating the securities laws.⁴³

The court of appeals supported its policy oriented holding by observing that the language of section 10(b) was not sufficiently clear to control the issue,⁴⁴ and that the legislative history of that section "is bereft of any explicit explanation of Congress' intent."⁴⁵ The court found a more persuasive guide for construing the contours of section 10(b) in the legislative history of section 21(d) of the 1934 Act.⁴⁶ Section 21(d) authorizes the SEC to bring injunctive actions to enforce the prohibitions of section 10(b).⁴⁷ The court was convinced that legislative discussion of that provision clearly indicated that Congress did not intend a scienter requirement for Commission injunctions.⁴⁸ Finally, the circuit court was satisfied that rejecting a scienter requirement for Commission injunctions to enforce section 10(b) was consistent with the overall enforcement scheme of the federal securities acts.⁴⁹

After concluding that negligence was the proper standard for liability under section 10(b),⁵⁰ the court of appeals proceeded to affirm the rule enunciated in its prior decisions that scienter is also not required in a Commission injunctive

diligence to be cast aside in the name of convenience." The public interest in accuracy of registration statements outweighs the potential burden of complying with due diligence requirements.) and *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854-55 (2d Cir. 1968) ("In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent . . . conduct has become unlawful.") *Id.* at 854-55. ("[T]he securities laws should be interpreted as an expansion of the common law . . . to effectuate the broad remedial design of Congress.") *Id.* at 855.

⁴¹ 605 F.2d at 621.

⁴² *Id.* "The essential nature of an SEC enforcement action is equitable and prophylactic; its primary purpose is to protect the public against harm, not to punish the offender." *Id.* (quoting *SEC v. Coven*, 581 F.2d 1020, at 1027-28 (2d Cir. 1978)).

⁴³ 605 F.2d at 621.

⁴⁴ *Id.*

⁴⁵ *Id.* (quoting *Hochfelder*, 425 U.S. at 201).

⁴⁶ *Id.* at 621-22.

⁴⁷ See note 28 *supra* for the relevant text of § 21(d).

⁴⁸ 605 F.2d at 622 n.14. The court found support for its reading of § 21(d) in the legislative history of the 1933 and 1934 Acts, *id.* at n.14, and the legislative reports to the Securities Acts Amendments of 1975, which amended § 21(d). *Id.* at 622.

⁴⁹ *Id.* at 622. The circuit court stated that *Hochfelder* reflected a concern that the absence of a scienter requirement for private damage actions under § 10(b) would render superfluous the statutory scheme of "express civil liability," and would significantly broaden the class of plaintiffs who could sue under this provision. *Id.* The court of appeals found no comparable provisions that would be nullified by permitting SEC enforcement actions to be predicated on a showing of negligence. *Id.* at 623. To the contrary, the court of appeals concluded that "to sanction § 10(b) injunctive relief on proof of negligence would be to harmonize the requirements of that section with the standards governing similar prophylactic provisions of the 1933 Act." *Id.*

⁵⁰ *Id.* at 623.

action under section 17(a) of the 1933 Act.⁵¹ The court based its reading of section 17(a) on its reasoning concerning section 10(b) and its previous decision in *SEC v. Coven*.⁵² In *Coven*, the court had observed that the language of section 17(a)(2) and 17(a)(3) gives no indication that civil liability was to be predicated on a showing of scienter.⁵³ The *Coven* court also found its reading of section 17(a) to be in accord with the legislative history of that section, stating that although Congress had considered a scienter requirement under that provision, instead it had "opted for liability without willfulness, intent to defraud, or the like."⁵⁴ Finally, the *Coven* court found nothing in the structure of remedies provided in the securities acts to suggest a scienter requirement under section 17(a) when enforced by commission injunctions.⁵⁵

Having determined that negligence was the appropriate standard of liability under sections 10(b) and 17(a), the court of appeals then considered whether the district court erred in enjoining defendant Aaron from committing further violations of the securities laws.⁵⁶ The court stated that the critical issue in determining whether the public interest requires the imposition of a permanent injunction is "whether there is a reasonable likelihood that the wrong will be repeated."⁵⁷ The court further stated that the commission of fraudulent acts in the past gives rise to an inference that such conduct may recur in the future.⁵⁸ In applying these principles to the instant case, the court determined that the nature of Aaron's past violations, which were rather flagrant and committed with scienter, and Aaron's continued protestations of innocence, were significant indicia of likely future misconduct.⁵⁹ The court of appeals thus concluded that a likelihood of future violations was indeed present, and proceeded to affirm the district court's grant of a permanent injunction against Aaron.⁶⁰

The Supreme Court granted defendant Aaron's petition for certiorari⁶¹ and reversed the court of appeals.⁶² The court HELD: the Commission must establish scienter⁶³ to enjoin violations of section 17(a)(1) of the 1933 Act, section

⁵¹ *Id.*

⁵² *Id.*

⁵³ 581 F.2d 1020, 1026 (2d Cir. 1978). See note 14 *supra* for the text of § 17(a).

⁵⁴ 581 F.2d at 1027.

⁵⁵ *Id.* at 1027. The circuit court observed that if a private action for damages were recognized under § 17(a), and if scienter were not required, the effect might be to negate the limitations on private actions for negligence contained in §§ 11, 12(2), and 15 of the 1933 Act, 15 U.S.C. §§ 77k, 77l(2), and 77o. 581 F.2d at 1027. While this structural consideration might auger for a scienter requirement in private actions under § 17(a), the court of appeals found it to be irrelevant as a basis for limiting liability with regard to SEC enforcement proceedings. *Id.*

⁵⁶ 605 F.2d at 623.

⁵⁷ *Id.*

⁵⁸ *Id.* at 624.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ 444 U.S. 914 (1979).

⁶² 446 U.S. at 702.

⁶³ The Court did not elaborate on the meaning of scienter beyond stating: "[t]he term 'scienter' is used throughout this opinion, as it was in *Ernst & Ernst v. Hochfelder* to refer to 'a mental state embracing intent to deceive, manipulate, or defraud.' We have no occasion here to address the question, reserved in *Hochfelder*, whether, . . . scienter may also include reckless behavior."

10(b) of the 1934 Act, and rule 10b-5 promulgated under that section of the 1934 Act.⁶⁴ The Court further held that the Commission need not establish a defendant's scienter to enjoin violations of section 17(a)(2) and 17(a)(3) of the 1933 Act.⁶⁵

This casenote will examine the question whether the *Aaron* Court was correct in holding that section 10(b) requires proof of scienter when enforced by Commission injunctions. The merits of the Court's reasoning will be evaluated and tested against an approach which would rely less on *Hochfelder* and the problematical statutory language of section 10(b) and more on factors which distinguish Commission injunctive actions from private actions for damages under that section. Analysis of the components of the *Hochfelder* opinion reveals the questionable precedential value of that decision for the issue before the *Aaron* Court. An inquiry focusing instead on the common law remedies for fraud, the legislative policy and statutory scheme of the 1934 Act, and the legislative history of amendments to the 1934 Act demonstrates that SEC injunctive relief should not be limited by a scienter requirement. It is submitted that *Aaron* was wrongly, or at least improvidently, decided. By requiring the SEC to prove scienter in most situations before it may obtain an injunction, the Court unnecessarily undercuts the Commission's authority to police the marketplace. Neither in *Hochfelder* nor in *Aaron*, however, did the Court clearly define the meaning of "scienter" under section 10(b).⁶⁶ Accordingly, it is submitted that the same considerations that militate against the imposition of a scienter standard in enforcement actions argue just as persuasively in favor of an expanded interpretation of the meaning of "scienter" in such actions.

I. THE AARON DECISION

At the outset of its opinion, the Court delineated a bifurcated approach for determining whether scienter may be a necessary element in SEC enforcement proceedings.⁶⁷ Under this approach, a court must determine first whether the substantive provision allegedly violated requires a showing of scienter, and second, whether the statutory provision authorizing injunctive relief requires

446 U.S. at 686 n.5. (citations omitted). The Court thus eschewed the task of clarifying the confused meaning of "scienter" as used in *Hochfelder*. See n.6 *supra*.

⁶⁴ 446 U.S. at 701-02.

⁶⁵ *Id.* at 702. Chief Justice Burger concurred with the opinion of the majority. *Id.* at 702-03. Justice Blackmun, joined by Justices Brennan and Marshall, concurred in part and dissented in part. *Id.* at 703-18.

⁶⁶ See notes 6 & 63 *supra*.

⁶⁷ 446 U.S. at 689. After stating that "resolution of [the scienter issue] could depend upon (1) the substantive provisions of § 17(a), § 10(b) and Rule 10b-5, or (2) the statutory provisions authorizing injunctive relief. . .," the Court then stated that it would examine "each" to determine the extent to which the respective provisions "may require proof of scienter." *Id.* Although the use of the word "or" might be construed as an assertion by the Court that the scienter issue could be resolved by reference to either the substantive provisions alone or the provisions authorizing injunctive relief alone, the Court's determination to examine "each" set of provisions, and its unwillingness to rule on the Commission's burden of proof in enforcement actions until it had completed its two step analysis, indicates the Court thought this bifurcated approach was mandatory.

scienter.⁶⁸ As applied to the instant case, this two-tiered test required first, an examination of the substantive provisions at issue, section 17(a) of the 1933 Act, section 10(b) of the 1934 Act, and rule 10b-5,⁶⁹ and second, a determination whether the provisions authorizing injunctive relief, section 20(b) of the 1933 Act, and section 21(d) of the 1934 Act, modify the substantive provisions so far as scienter is concerned.⁷⁰ Only after completing this two step analysis was the Court prepared to rule on whether the Commission must establish scienter to enjoin violations of section 17(a) and section 10(b).⁷¹

As the first step of its analysis, the Court examined section 10(b). It found as compelling precedent *Ernst & Ernst v. Hochfelder*.⁷² The *Hochfelder* Court based its conclusion that scienter was required in private damage actions under section 10(b) on the text and legislative history of that provision, and the statutory scheme of the 1933 and 1934 Acts.⁷³ The *Aaron* Court, unwilling to acknowledge "policy" as a basis for the *Hochfelder* conclusion,⁷⁴ began its discussion of the state of mind required for injunctive liability under section 10(b) by summarizing the reasoning of *Hochfelder*. The Court stated first that *Hochfelder* had deemed the text of section 10(b) to "quite clearly evince a congressional intent to proscribe only 'knowing or intentional misconduct.'"⁷⁵ The *Aaron* Court continued by observing that the legislative history of that provision, though "bereft of any explicit explanation of Congress' intent," contained "no indication . . . that § 10(b) was intended to proscribe conduct not involving scienter."⁷⁶ The *Aaron* Court then took note of the concern expressed in

⁶⁸ *Id.*

⁶⁹ *Id.* at 689-700. In part II, section A of its opinion, the *Aaron* Court discussed the issue of a scienter requirement under § 10(b). *Id.* at 689-95. In part II, section B, the Court examined the issue of scienter under § 17(a). *Id.* at 695-700.

⁷⁰ *Id.* at 700-01. (part II, section C).

⁷¹ *Id.*

⁷² *Id.* at 690, 691, 695.

⁷³ See 425 U.S. at 197-214. Although the *Hochfelder* Court was unwilling to rely expressly on "policy" to support its decision, policy considerations may well have been the underlying foundation for those supports on which the Court expressly relied. At the conclusion of its opinion, the *Hochfelder* Court stated that since "the language and history of § 10(b) [are] dispositive of the appropriate standard of liability," it had no occasion to examine "considerations of 'policy' set forth by the parties." 425 U.S. at 214 n.33. After making this disclaimer, however, the Court proceeded to note that "the standard urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon [experts rendering opinions] with respect to matters under the Acts." *Id.* In a more general vein, the Court reiterated its concern previously expressed in *Blue Chip Stamps*, 421 U.S. at 747-48, that "the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good." *Id.* The *Hochfelder* Court concluded by stating "[a]cceptance of respondents' view would extend new frontiers to the 'hazards' of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress." *Id.* Thus, it appears that the *Hochfelder* Court was quite concerned about the policy ramifications of a relaxed standard of liability under § 10(b). This view of *Hochfelder* was endorsed by Justice Blackmun in his dissent in *Aaron*, where he stated that the "broadening of the class of plaintiff who may sue in this area of the law . . . has been an animating concern of the Court's decisions limiting the scope of private damage actions under § 10(b)." 446 U.S. at 713 n.4. (Blackmun, J., dissenting) (emphasis added). Justice Blackmun cited as support for this proposition footnote 33 of the *Hochfelder* opinion. *Id.*

⁷⁴ Compare 446 U.S. at 690-91 & n.9 with 425 U.S. at 214 n.33.

⁷⁵ 446 U.S. at 690.

⁷⁶ *Id.*

Hochfelder that premising civil liability under section 10(b) would upset the statutory scheme.⁷⁷ The *Hochfelder* Court had observed that when Congress intended a negligence standard under other provisions of the 1933 and 1934 Acts, it said so expressly⁷⁸ and subjected such actions to significant procedural restraints not applicable to section 10(b).⁷⁹ Finally, the *Hochfelder* Court concluded by reasoning that since the Commission's rule-making power is necessarily limited to its statutory authority, rule 10b-5 must likewise be restricted to conduct involving scienter.⁸⁰

After reviewing its reasoning in *Hochfelder*, the *Aaron* Court concluded that since the language and legislative history of section 10(b) apply with equal force to private damage actions and Commission injunctive actions, scienter must be an element of a violation of that provision "regardless of the identity of the

⁷⁷ *Id.*

⁷⁸ 425 U.S. at 207. The *Hochfelder* Court referred to § 11 of the 1933 Act, 15 U.S.C. § 77k (1976) as an example of an express civil remedy allowing recovery for negligent conduct. 425 U.S. at 208-09. The Court characterized the "due diligence" defense accorded experts and accountants under § 11(b)(3)(B)(i), 15 U.S.C. § 77k(b)(3)(B)(i) as "in effect" a negligence standard. 425 U.S. at 208. "An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that 'after reasonable investigation' he had 'reasonable ground[s] to believe' that the statements for which he was responsible were true and there was no omission of a material fact." *Id.* at 208. The Court noted that other individuals who sign the registration statement, directors of the issuer, and the underwriter of the securities, are also accorded a complete defense against civil liability based on the exercise of reasonable investigation and a reasonable belief that the registration statement was not misleading under §§ 11(b)(3)(A), (C), (D), 15 U.S.C. § 77k(b)(3)(A), (C), (D) (1976). 425 U.S. at 208 n.26. The *Hochfelder* Court's characterization of the "due diligence" defense under § 11 as in effect a negligence standard is not entirely accurate. In a typical negligence action, the plaintiff must show that defendant failed to exercise due care. In a suit under § 11, however, the defendant bears the burden of coming forward with evidence that he exercised reasonable care in helping to prepare the registration statement.

The *Hochfelder* Court also asserted that a negligence standard obtains under sections 12(2) and 15 of the 1933 Act, 15 U.S.C. §§ 77(2) and 77o, but did not expand on this statement. 425 U.S. at 208-09.

⁷⁹ *Id.* Section 11(e) of the 1933 Act, 15 U.S.C. § 77k(e) (1976), authorizes courts to require plaintiffs suing under §§ 11, § 12(2), or § 15 to post a bond for costs, including attorneys' fees. Judicial construction of this provision generally has required posting of bond only where the action does not appear likely to succeed. *Dabney v. Alleghany Corp.*, 164 F. Supp. 28, 33 (S.D.N.Y. 1958). Section 11(e) also authorizes a court to assess costs at the conclusion of the litigation, in specified circumstances. Section 13, 15 U.S.C. § 77m (1976), imposes a statute of limitations of one year applicable to actions brought under §§ 11, 12(2), and 15, running from the time the violation was or should have been discovered, and in no event to exceed three years from the time the security was offered to the public. 425 U.S. at 210.

There is no statute of limitations provided for civil actions under § 10(b). Thus, the statute of limitations of the forum state is followed as in other cases of judicially implied remedies. *See, e.g.*, *Holmberg v. Armbrrecht*, 327 U.S. 392, 395 (1946). Generally, state statutes of limitations are longer than the one-year period provided under § 13. 3 LOSS, *supra* note 4, at 1773-74. In a § 10(b) suit, there is no bond-posting requirement, and a district court's power to award attorneys' fees is sharply limited. *See, e.g.*, *F.D. Rich Co. v. United States ex. rel. Industrial Lumber Co.*, 417 U.S. 116, 129 (1974) ("attorneys' fees may be awarded to a successful party when his opponent has acted in bad faith, vexatiously, wantonly, or for oppressive reasons").

⁸⁰ 446 U.S. at 691. In *Hochfelder*, the Court observed that "[v]iewed in isolation the language of subsection (b), and arguably that of subsection (c) [of rule 10b-5] could be read as proscribing" conduct not involving scienter. 425 U.S. at 212.

plaintiff or the nature of the relief sought.”⁸¹ The *Aaron* Court admitted that the third prong of the *Hochfelder* analysis, the structure of civil liability provisions in the 1933 and 1934 Acts, had no applicability to the instant case.⁸² Nevertheless, the Court maintained that the language of the statute was dispositive in *Hochfelder*, thus intimating that the remaining grounds for the conclusion in *Hochfelder* were mere dicta.⁸³

The Court's strict reliance on the language of the statute, as construed by *Hochfelder*, differed sharply from the approach urged by the SEC. The Commission had argued that it was more appropriate to construe section 10(b) by reference to cases involving Commission suits for injunctive relief than to focus solely on *Hochfelder*, which involved a private damage action.⁸⁴ Accordingly, the Commission urged the Court to follow the reasoning of *SEC v. Capital Gains Research Bureau*.⁸⁵ In *Capital Gains*, the Supreme Court held that in an SEC enforcement action⁸⁶ against an investment advisor for deceptive conduct proscribed by section 206(2) of the Investment Advisors Act of 1940,⁸⁷ the Commission is not required to prove intent to defraud.⁸⁸ The Court had based its conclusion on evidence of legislative intent,⁸⁹ developments in the common law

⁸¹ 446 U.S. at 691.

⁸² *Id.* at 691 n.9.

⁸³ *Id.*

⁸⁴ *Id.* at 691-94.

⁸⁵ 375 U.S. 180 (1963).

⁸⁶ The statutory provision pursuant to which the SEC sought injunctive relief in *Capital Gains* was § 209(e) of the Investment Advisors Act, 15 U.S.C. § 80b-9(e) (1976), which provides in relevant part:

Whenever it shall appear to the Commission that any person has engaged, is engaged, or is about to engage in any act or practice constituting a violation of any provision of this subchapter, or of any rule, regulation, or order hereunder, . . . it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices . . . Upon a showing that such person has engaged, is engaged, or is about to engage in any such act or practice, . . . a permanent or temporary injunction or decree or restraining order shall be granted without bond.

Id.

Section 209(e) is similar to § 20(b) of the 1933 Act and § 21(d) of the 1934 Act. See note 28 *supra*. One distinction between the provisions authorizing injunctive relief, however, is that under § 209(e) of the Investment Advisors Act, the SEC may obtain an injunction upon a bare showing of past violations of the Act; under § 20(b) and § 21(d) of the 1933 and 1934 Acts the Commission may obtain injunctive relief only upon a showing that defendant is presently violating, or is about to violate a provision of the Act. See note 28 *supra*.

⁸⁷ 15 U.S.C. § 80b-6 (1976). This section prohibits any act or practice of an investment advisor that “operates as a fraud or deceit upon any client or prospective client.” Note the similarity to § 17(a)(3) of the 1933 Act, set forth in note 14 *supra*.

The injunction sought in *Capital Gains* was to require investment advisors to disclose to their clients whether they were engaged in “scalping” the securities they recommended. Scalping refers to a practice whereby an investment adviser purchases shares of a security for his own account shortly before recommending the same security to investors, and then promptly sells his shares at a profit upon the rise in their market value following the recommendation. 375 U.S. at 181, 183.

⁸⁸ 375 U.S. at 195.

⁸⁹ *Id.* at 186-92. The Court observed that the legislative history of the Investment Advisors Act reflected both a broad congressional intent “to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested,” *id.* at 191-92, and a specific intent to prohibit

of fraud,⁹⁰ and the practical effect of a scienter requirement on achieving the purposes of the legislation.⁹¹ The Court stressed that the Commission's suit was equitable in nature and that in such suits the common law did not require proof of scienter.⁹² The *Capital Gains* Court thus sought to harmonize the requirements for equitable relief from fraud with the requirements for Commission injunctions under the securities laws.

In *Aaron*, the Commission argued that the emphasis in *Capital Gains* upon the distinction between fraud at law and fraud in equity should guide a construction of section 10(b) in a Commission suit for injunctive relief.⁹³ The *Aaron* Court refused to be guided by the reasoning of *Capital Gains*, however, and proceeded to distinguish the provision at issue in *Capital Gains* from section 10(b) on three grounds: legislative history, statutory language, and the type of transaction regulated. The Court first noted that while there was "strong support" in the legislative history for the conclusion in *Capital Gains* that the Commission need not prove intent to enjoin violations of section 206(2),⁹⁴ the legislative history of section 10(b) "points towards a scienter requirement."⁹⁵ Secondly, the Court observed that the provision at issue in *Capital Gains*, which makes unlawful any practice "which operates . . . as a fraud or deceit," focuses on the fraudulent effect of a particular practice, and not on the state of mind of the investment advisor.⁹⁶ By contrast, the language of section 10(b) refers to "knowing or intentional misconduct."⁹⁷ Finally, the Court noted that the statutory provision involved in *Capital Gains* regulated the "special fiduciary relationship" between an investment advisor and his client, whereas section 10(b) "applies with equal force" to both fiduciary and nonfiduciary transactions in securities.⁹⁸ The Court

"trading by investment counselors for their own account in securities in which their clients were interested." *Id.* at 189. In light of this evidence, the Court reasoned that requiring proof of scienter would run counter to the expressed intent of Congress. *Id.* at 192.

⁹⁰ *Id.* at 192-95.

⁹¹ *Id.* at 200-01. The practical difficulty of proving scienter, the Court insisted, would nullify the protective purposes of the statute. *Id.* at 200. It was the Court's view that requiring the courts or the Commission to "separate the mental urges of an investment advisor" would frustrate the policy of maintaining "public confidence in the securities industry" and preserving "the economic health of the country." *Id.* at 200, 201.

⁹² *Id.* at 192-95. "Fraud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element." *Id.* at 194 (quoting W. DEFUNIAK, HANDBOOK OF MODERN EQUITY 235 (2d ed. 1956) (brackets in original)).

The Court also noted that in a suit against a fiduciary such as an investment adviser, it was not necessary to establish all the elements of fraud that would be required in a suit against a party to an arms-length transaction. *Id.*

⁹³ 446 U.S. at 693-94.

⁹⁴ *Id.* at 694.

⁹⁵ *Id.* This observation, which the Court said was supported by the *Hochfelder* opinion, is not entirely accurate. The legislative history of § 10(b) was the weakest ground for the *Hochfelder* holding. In discussing the import of the hearings and reports it reviewed, the *Hochfelder* Court was only able to say "[t]here is no indication . . . that § 10(b) was intended to proscribe conduct not involving scienter." 425 U.S. at 202. Moreover, the *Aaron* Court expressly stated that "the language of the statute . . . was sufficient, standing alone, to support the Court's conclusion that scienter is required in a private damage action under § 10(b)." 446 U.S. at 691 n.9. Thus, the value of the excursion into the legislative history of § 10(b) by the Court in *Hochfelder* is unclear.

⁹⁶ 446 U.S. at 694.

⁹⁷ *Id.*

⁹⁸ *Id.* at 694-95. In the past, some courts had considered the status of the defendant as a

concluded, therefore, that *Hochfelder*, rather than *Capital Gains* was the controlling precedent, and laid down the flat rule that under all circumstances, scienter is a necessary element of a violation of section 10(b) and rule 10b-5.⁹⁹

After ruling on section 10(b), the Court then turned to the issue whether proof of scienter is a necessary element of a violation of section 17(a) of the 1933 Act.¹⁰⁰ The Court concluded that scienter is an element of a section 17(a)(1) violation, but not of violations under sections 17(a)(2) or 17(a)(3).¹⁰¹ Although both Aaron and the SEC urged the Court to adopt a uniform culpability requirement under section 17(a),¹⁰² the Court insisted that the text of section 17(a) was drafted in such a manner as to "compel the conclusion that scienter is required under one subparagraph but not under the other two."¹⁰³ In this regard, the Court found the terms "device," "scheme," and "artifice" contained in subparagraph (1) of section 17(a)¹⁰⁴ to all connote conduct involving scienter.¹⁰⁵ In contrast, the Court found the language of subparagraph (2), which prohibits obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact,"¹⁰⁶ to be devoid of any suggestion of a scienter requirement.¹⁰⁷ Similarly, the Court construed subparagraph (3), which makes unlawful practices which "operate or would operate as a fraud or deceit,"¹⁰⁸ as focusing on the effect of particular conduct on members of the investing public, rather than upon the culpability of the perpetrator.¹⁰⁹ It therefore determined that scienter was inappropriate as a precondition for liability under section 17(a)(3).¹¹⁰ Convinced that its linguistic analysis of section 17(a) was correct,¹¹¹ the Court proceeded to discuss the legislative history of the provision.¹¹² The Commission contended that the elimination of specific language of intent¹¹³ from earlier drafts of section 17(a) indicated that Congress had considered and rejected a scienter requirement under all three clauses of the

fiduciary or nonfiduciary in determining either the need to prove scienter or the degree of scienter required to be shown. See, e.g., *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 485 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980); *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 44-45 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978).

⁹⁹ 446 U.S. at 695.

¹⁰⁰ *Id.* While noting that it was "cognizant" that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed not technically and restrictively, but flexibly to effectuate its remedial purposes," the Court at the outset of its discussion reiterated its recently expressed view that "generalized references to the remedial purposes of the securities laws will not justify reading a provision more broadly than its statutory language and the statutory scheme reasonably permit." *Id.* (citations omitted).

¹⁰¹ 446 U.S. at 697.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ See note 14 *supra* for the text of section 17(a)(1).

¹⁰⁵ 446 U.S. at 696.

¹⁰⁶ See note 14 *supra* for the text of section 17(a)(2).

¹⁰⁷ 446 U.S. at 696.

¹⁰⁸ See note 14 *supra* for the text of section 17(a)(3).

¹⁰⁹ 446 U.S. at 697.

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.* at 697-700.

¹¹³ *Id.* at 698-99. Earlier drafts of section 17(a) had contained the word "willfully" at the beginning of the provision. In addition, the phrase "with intent to defraud" had modified the first clause "to employ any device, scheme, or artifice." *Id.*

provision.¹¹⁴ The Court rejected this argument, however, emphasizing that the Conference report did not address the question of scienter under section 17(a).¹¹⁵ The Court thus determined that the legislative history, although ambiguous, could be read in a manner consistent with the plain meaning of section 17(a).¹¹⁶ Concluding its discussion of section 17(a), the Court refused to entertain policy arguments advanced by the parties, asserting that "the language and legislative history of § 17(a) are dispositive."¹¹⁷

Proceeding from its conclusion that sections 10(b) and 17(a)(1) embody a scienter requirement, while sections 17(a)(2) and 17(a)(3) do not, the Court moved to the second tier of its analysis to determine whether the provisions authorizing injunctive relief, section 20(b) of the 1933 Act and 21(d) of the 1934 Act,¹¹⁸ "modify the substantive provisions at issue . . . so far as scienter is concerned."¹¹⁹ The Court summarily concluded that neither the language nor the legislative history of these provisions indicated a congressional intent to add to or detract from the requisite showing of scienter under section 10(b) or section 17(a).¹²⁰ Having completed its bifurcated test for ascertaining whether scienter is required in SEC enforcement proceedings, the Court was then able to hold that, with respect to section 10(b) and section 17(a)(1) violations, the Commission must establish scienter to obtain injunctive relief, but need not establish scienter to enjoin violations of sections 17(a)(1) and 17(a)(2).¹²¹

¹¹⁴ *Id.* at 699.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 699-700.

¹¹⁷ *Id.* at 700 n.19.

¹¹⁸ Section 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), authorizes the Commission to bring injunctive actions to enforce the provisions of the statute and the rules promulgated thereunder. See note 28 *supra* for the text of § 20(b). Section 21(d) of the 1934 Act, 15 U.S.C. § 78u(d) (1976), authorizes the Commission to bring injunctive actions to enforce the 1934 Act. See note 28 *supra* for the relevant portion of § 21(d).

¹¹⁹ 446 U.S. at 700.

¹²⁰ *Id.* In the context of the issue of a scienter requirement under § 10(b), the Court considered the subsequent legislative history of § 21(d) of the 1934 Act. The Commission had argued that its administrative interpretation of § 10(b) as not requiring proof of scienter in injunctive proceedings enjoyed congressional approval. *Id.* at 694 n.11. Congress had been expressly informed of the Commission's interpretation on two occasions when significant amendments to the securities laws were enacted — the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, and the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 — and on each occasion Congress left the administrative interpretation undisturbed. See S. REP. NO. 94-75, 94th Cong., 1st Sess. 76 (1975), reprinted in [1975] U.S. CODE CONG. & AD. NEWS 179; H. R. REP. NO. 95-640, 95th Cong., 1st Sess. 10 (1977). The Court, however, was not impressed. It stated that since "the legislative consideration of those statutes was addressed principally to matters other than at issue here, . . . the failure of Congress to overturn the Commission's interpretation falls far short of . . . support[ing] a construction of § 10(b) so clearly at odds with its plain meaning and legislative history." 446 U.S. at 694 n.11.

¹²¹ *Id.* at 701-02. Although the Court held that the Commission need not establish scienter to enjoin violations of §§ 17(a)(2) and 17(a)(3), the Court took pains to emphasize that a defendant's scienter would have some bearing on a district court's decision to enjoin persons violating or about to violate subparagraphs (2) or (3) of § 17(a). *Id.* at 701. The Court noted that where the Commission is seeking to enjoin persons *about* to engage in acts which *will* constitute a violation of those provisions, "the Commission must establish a sufficient evidentiary predicate to show that such future violations may occur." *Id.* at 701 (citations omitted). The Court further stated that an important factor in establishing this evidentiary foundation is "the degree of inten-

In dissent, Justice Blackmun, joined by Justices Brennan and Marshall, argued that neither section 17(a)(1) of the 1933 Act, nor section 10(b) of the 1934 Act requires the SEC to prove scienter as an element of a civil injunctive action.¹²² Relying on the absence of specific words of intent in either provision,¹²³ the dissent argued that the operative terms of section 17(a)(1) and section 10(b) admit an interpretation, in the context of Commission injunctive actions, that reaches deceptive practices whether scienter is present or not.¹²⁴ The dissent also criticized the Court's failure to harmonize the antifraud provisions at issue with the prevailing equity practice at the time the securities laws were enacted.¹²⁵ That practice was not to require proof of scienter in actions seeking equitable relief against fraudulent practices.¹²⁶ Justice Blackmun further argued that the Court's reliance on *Hochfelder* was misplaced, since the structural and policy considerations¹²⁷ advanced in support of a scienter requirement for private damage actions have no application to Commission statutory injunctions.¹²⁸ The dissent also stressed that the majority decision would upset the statutory scheme of civil remedies that may be pursued by the Commission.¹²⁹

II. A CRITIQUE OF THE AARON OPINION

Aaron evinces a narrow and literal construction of statutes that were once deemed broad and remedial.¹³⁰ The decision is significant in several respects. The most important consequence of *Aaron* is that it circumscribes the Commission's ability to enjoin deceptive conduct. By limiting the prohibitions of section 10(b) and section 17(a)(1) to conduct involving scienter, the Court not only constricts the range of deceptive conduct that is unlawful, but also erects a more difficult burden of proof for the Commission than would obtain under a negligence standard. Whereas proving negligence involves merely an objective

tional wrongdoing evident in a defendant's past conduct." *Id.* at 701 (citation omitted). Moreover, even where a defendant is presently violating the securities laws, the Court observed that a district court may properly consider scienter or lack of it as an aggravating or mitigating factor in deciding whether to grant injunctive relief. *Id.* at 701.

¹²² *Id.* at 703-04 (Blackmun, J., dissenting). Justice Blackmun, joined by Justices Brennan and Marshall, concurred in the Court's judgment that §§ 17(a)(2) and (3) of the 1933 Act do not require proof of scienter when enforced by Commission injunctions. *Id.* at 703.

¹²³ *Id.* at 706. The dissent stressed that when Congress wanted to specify a prerequisite of knowledge or intent for violations of the securities laws it had done so by employing the word "willfully." *Id.* The dissent found the omission of this term in § 10(b) and § 17(a)(1) particularly significant in light of the legislative history of § 17(a). Congress had considered and rejected the use of specific words of intent — "willfully" and "with the intent to defraud" — in enacting § 17(a). *Id.* at 706 n.1.

¹²⁴ *Id.* at 707.

¹²⁵ *Id.* at 709-12.

¹²⁶ *Id.* at 709.

¹²⁷ *Id.* at 713 n.4. The dissent stated, "[n]or is there any danger that actions for prophylactic relief brought by the Commission will result in the 'broadening of the class of plaintiff who may sue in this area of the law,' [which] has been an animating concern of the Court's decisions limiting the scope of private damage actions under § 10(b)." *Id.* See *Hochfelder*, 425 U.S. 185, 214 n.33.

¹²⁸ 446 U.S. at 713.

¹²⁹ *Id.* at 713-15.

¹³⁰ *Id.* at 715.

inquiry regarding whether the defendant exercised reasonable care, proving scienter requires a problematical inquiry into the defendant's subjective state of mind. The decision also appears virtually to eviscerate the doctrine of equitable fraud in the context of the federal securities laws,¹³¹ thus eliminating the dichotomy between SEC enforcement actions and private damage actions. The decision may also portend a shift in the Court's view of the nature of injunctive relief. In his concurring opinion, Chief Justice Burger characterized an injunction as a "drastic remedy . . . not [to] be obtained against one acting in good faith."¹³² Prior Supreme Court opinions, in contrast, had described the remedy as a "mild prophylactic."¹³³ Finally, the decision reveals that the Supreme Court apparently now views the securities laws as unambiguous on their face. Prior to *Aaron*, the meaning of section 10(b) and section 17(a) had engendered much disagreement among courts and commentators. The Supreme Court, however, was able to ascertain the "plain meaning" of those provisions by reference to Webster's dictionary.¹³⁴ Such a reading allows decisionmaking without reference to the remedial purposes of the securities statutes, or other considerations of public policy.

The following analysis will critically evaluate the *Aaron* Court's resolution of the issue of scienter under section 10(b). An analysis of the Court's ruling on section 17(a) of the 1933 Act is beyond the scope of this casenote. The Court's reliance on *Hochfelder* will be tested for its merit, as will the conclusion of the *Hochfelder* Court that scienter is mandated by the language and legislative history of section 10(b). After the ambiguity of the text and legislative history of that section has been revealed, other sources for ascertaining the provision's import will be surveyed. An examination of the requirements for relief from fraud under the common law, the legislative policy and statutory scheme of the 1934 Act and the legislative history of amendments to the 1934 Act will indicate that a scienter requirement is inappropriate in the context of SEC injunctive relief under section 10(b).

A. *The Language and Legislative History of Section 10(b)*

To determine whether scienter is required for a violation of section 10(b), the *Aaron* Court stated that although the issue before it was expressly reserved in

¹³¹ Until 1975, the Court's first principle of statutory construction in the securities law area was that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed not technically and restrictively, but flexibly to effectuate its remedial purposes." See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963). See also *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 350-51 (1943). Recent decisions of the Supreme Court, however, have retreated from this principle, emphasizing instead that the starting point in any analysis of the securities laws must be the language of the statute. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 226 (1980); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15-16 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558 (1979); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring).

¹³² 446 U.S. at 703 (Burger, C.J., concurring).

¹³³ See, e.g., *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 193 (1963).

¹³⁴ See text and notes at note 156 *infra*.

Hochfelder,¹³⁵ it would nevertheless be guided by the reasoning at that decision.¹³⁶ In its review of the various grounds for the conclusion in *Hochfelder* that an allegation of scienter is required to state a private cause of action for damages under section 10(b), the *Aaron* Court deemed the strongest basis for that conclusion to be the "plain meaning" of the language of section 10(b).¹³⁷ That section makes it unlawful to use or employ any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security.¹³⁸ The *Aaron* Court summed up the position of the *Hochfelder* Court by asserting: "[i]t was the view of the Court [in *Hochfelder*] that the terms 'manipulative,' 'device,' and 'contrivance' — whether given their commonly accepted meaning or read as terms of art — quite clearly evinced a congressional intent to proscribe only 'knowing or intentional misconduct.'"¹³⁹

Although the Court in *Hochfelder* did maintain that the language of section 10(b) was unambiguous in the context of a private suit for damages,¹⁴⁰ *Aaron*, nevertheless, seems to have exaggerated the strength of *Hochfelder*'s textual analysis of that provision. *Aaron* read *Hochfelder* as stating that the language of section 10(b) "clearly evinced a congressional intent to proscribe only knowing or intentional misconduct."¹⁴¹ The relevant passage in *Hochfelder*, however, stated only that the operative terms of that section "strongly suggest . . . [section 10(b)] was intended to proscribe knowing or intentional misconduct."¹⁴² Elsewhere in the *Hochfelder* opinion the Court was even less bold when it averred that the terms "device" and "contrivance" referred to conduct "quite different from negligence."¹⁴³ To say statutory language "strongly suggests" congressional intent is not as emphatic as saying that such language "clearly evinces" congressional intent. Similarly, conduct "different than negligence" is not necessarily "knowing or intentional misconduct."

In addition to overstating the conclusion *Hochfelder* drew from its analysis of section 10(b), *Aaron* also appears to have exaggerated the depth of *Hochfelder*'s textual analysis of that provision. *Aaron* implied that the *Hochfelder* opinion read the terms "manipulative," "device," and "contrivance" as "terms of art" as well as for their "commonly accepted meanings."¹⁴⁴ In fact, *Hochfelder* construed only the term "manipulative" as a term of art.¹⁴⁵ The terms "device" and "contrivance" were construed not as terms of art, but solely by reference to their "commonly accepted meanings."¹⁴⁶ It is evident, therefore, that *Aaron*

¹³⁵ 446 U.S. at 689-90. See 425 U.S. at 193 n.12.

¹³⁶ 446 U.S. at 690.

¹³⁷ *Id.*

¹³⁸ See note 11 *supra* for the text of section 10(b).

¹³⁹ 446 U.S. at 690.

¹⁴⁰ 425 U.S. at 200-01. See text and notes at notes 144-46 *infra*.

¹⁴¹ 446 U.S. at 690.

¹⁴² 425 U.S. at 197.

¹⁴³ *Id.* at 199.

¹⁴⁴ 446 U.S. at 690. The connotations of "deceptive" were not even addressed by the *Hochfelder* Court. See 425 U.S. at 199.

¹⁴⁵ 425 U.S. at 199. The *Hochfelder* Court merely asserted that "manipulative" "is and was virtually a term of art when used in connection with securities markets." *Id.* The Court did not state its reasoning in reaching this conclusion. *Id.*

¹⁴⁶ *Id.* at 199 & n.20. The *Hochfelder* Court merely stated its conclusion that the terms

attempted to re-shape the contours of the *Hochfelder* opinion. *Aaron* made *Hochfelder*'s analysis of the language of section 10(b) appear more forceful and more convincing that it really was.

The *Aaron* Court also failed to appreciate the limited circumstances under which *Hochfelder* concluded that the statutory language required proof of scienter. *Hochfelder* stated only that the language of section 10(b) was clear in the context of private damage actions.¹⁴⁷ It specifically reserved the issue whether proof of scienter was required in the context of Commission injunctive actions under section 10(b).¹⁴⁸ The Court evidently believed that a different analysis would apply to Commission suits for injunctive relief.¹⁴⁹ *Aaron*, however, appropriated *Hochfelder*'s textual analysis of section 10(b) and applied that analysis without reservation to Commission injunctive actions under the same section.¹⁵⁰ The Court's insensitivity to the limited context in which *Hochfelder* examined the text of section 10(b) enabled *Aaron* to apply the reasoning of *Hochfelder* beyond its intended scope.

The structure of the *Hochfelder* opinion casts further doubt on the precedential value of that decision to the issue before the *Aaron* Court. The *Aaron* Court asserted that the language of the statute was sufficient grounds, standing alone, to support the conclusion in *Hochfelder* that scienter is required in private damage actions under section 10(b).¹⁵¹ The relevant passage of the *Hochfelder* opinion, however, suggests the Court was not prepared to base its conclusion solely on the statutory text.¹⁵² The *Hochfelder* Court found the connotations of scienter in the text of section 10(b) sufficiently compelling to suggest that its textual analysis alone *might* justify its reading of that section.¹⁵³ The Court nevertheless elected to offer a broader justification for its holding in the structure

"manipulative," "device," and "contrivance" referred to conduct "quite different from negligence," and then in a footnote laid out Webster's definitions of "device," "contrivance" and "contrive." *Id.*

¹⁴⁷ *Id.* at 200-01. At the conclusion of its discussion of the language of § 10(b), the *Hochfelder* Court made clear that it was speaking only of "judicially implied liability." *Id.* at 200. It then continued, "mindful that the language of a statute controls when sufficiently clear in its context, further inquiry may be unnecessary." *Id.* at 201 (citations omitted). The Court had not yet discussed the legislative history of § 10(b) and the statutory scheme of express civil liability. Thus, the Court could not have been saying that the language of § 10(b) was clear in the context of the legislative history or the statutory scheme. Accordingly, the only "context" in which the text of § 10(b) could be "clear" would be in the context of private damage actions, as opposed to Commission injunctive actions and criminal actions brought by Justice Department to enforce § 10(b).

¹⁴⁸ 425 U.S. at 193 n.12.

¹⁴⁹ *Id.* After stating that it would not "consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b)," the *Hochfelder* Court then cited to *SEC v. Capital Gains Research Bureau*. The Court in *Capital Gains* insisted that proof of scienter was not required in suits for equitable relief, 375 U.S. at 193, and characterized an injunction as equitable in nature. *Id.* at 192-93.

¹⁵⁰ 446 U.S. at 691. "Two of the three factors relied upon in *Hochfelder* — the language of § 10(b) and its legislative history — are applicable whenever a violation of § 10(b) . . . is alleged, whether in a private cause of action for damages or in a Commission injunctive action under § 21(d)." *Id.*

¹⁵¹ *Id.* at n.9.

¹⁵² 425 U.S. at 201.

¹⁵³ *Id.*

of the civil liability provisions of the 1933 and 1934 Acts.¹⁵⁴ *Hochfelder's* readiness to find other grounds for its holding suggests the Court was not as confident in the plain meaning of section 10(b) as was the *Aaron* Court. It also suggests that *Hochfelder* stood on two legs rather than one.

The *Aaron* Court, however, concluded that *Hochfelder's* concern for the statutory scheme was mere surplusage, and the holding of *Hochfelder* could easily be supported by the single leg of textual analysis. In order to augment this single support and employ it to support its own conclusion, the *Aaron* Court overstated the strength of *Hochfelder's* textual analysis of section 10(b) and glossed over the limited context in which it was conducted. In this fashion, *Aaron* hammered *Hochfelder* into a shape that justified its holding that the Commission must prove scienter under section 10(b).

Despite the *Aaron* Court's conviction that the prohibition against "manipulative or deceptive devices or contrivances" in section 10(b) is clear in any context, the text of that provision is in some respects ambiguous. Since the proscriptions of section 10(b) are phrased in the disjunctive, each operative term must be given its separate meaning.¹⁵⁵ Thus, while the common meaning of "device or contrivance" suggests conduct that was planned or contemplated, it does not require intentionally deceptive conduct.¹⁵⁶ Moreover, the word "device" has been construed by the Supreme Court and Congress to encompass conduct not involving scienter. Although scienter traditionally has been an element of common law fraud, the Supreme Court has held that "a device need not be necessarily fraudulent."¹⁵⁷ Furthermore, the prohibition of "any manipulative, deceptive, or other fraudulent device or contrivance," contained in section 15(c)(1) of the Securities Exchange Act¹⁵⁸ has been construed by the SEC, with express congressional approval, to encompass negligent conduct as well as intentional fraud.¹⁵⁹ In addition, the Senate Committee Report of the 1934 Act used "device" synonymously with "practice" in describing the "devices" forbidden by section 10(b).¹⁶⁰ The word "practice" denotes an "action" or

¹⁵⁴ 425 U.S. at 206-11.

¹⁵⁵ 446 U.S. at 707 (Blackmun, J., dissenting).

¹⁵⁶ "Device" has been defined as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice." WEBSTER'S INTERNATIONAL DICTIONARY 713 (2d ed. 1934). "Contrivance" has been defined as an "[a]ct or faculty of contriving; maneuvering; invention or inventive ability." *Id.* at 580.

¹⁵⁷ *Armour Packing Co. v. United States*, 209 U.S. 56, 71 (1908). In construing the prohibition in the Elkins Act, 32 Stat. 847, 49 U.S.C. § 41(1) (1970), of all "devices" to obtain rebates or preferences, the Supreme Court stated, "[h]ad it been the intention of Congress to limit . . . fraudulent schemes or devices . . . to those operating only by dishonest, underhanded methods, it would have been easy to have so provided in words that would be unmistakable in their meaning. A device need not necessarily be fraudulent." 209 U.S. at 71.

¹⁵⁸ 15 U.S.C. § 78o(c)(1) (1976).

¹⁵⁹ In 1937, pursuant to its rulemaking power under § 15(c)(1) of the 1934 Act, the Commission provided by rule that § 15(c)(1) made unlawful "any act, practice, or course of business which operates or would operate as a fraud or deceit." 17 C.F.R. § 240.15c1-2. In 1938, while amending § 15(c), Congress considered and expressly approved the Commission's rule. H. R. REP. NO. 2307, 75th Cong., 3d Sess. 10 (1938); S. REP. NO. 1455, 75th Cong., 3d Sess. 4, 10 (1938); *Regulation of Over-the-Counter Markets: Hearings on S. 3255, H. R. 9634 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. 13-14, 84-86 (1938).

¹⁶⁰ See J. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934).

"deed" and does not imply intentional wrongdoing.¹⁶¹ Thus, it is not clear that the terms "device" and "contrivance" incorporate a scienter requirement. The adjectives "manipulative" and "deceptive," which modify the nouns "device" and "contrivance," however, may reveal more clearly what kind of conduct is proscribed. The word "manipulative" does connote scienter.¹⁶² "Deceptive," in contrast, is generally recognized to refer to the misleading effect of a practice, rather than the actor's state of mind. The word suggests no requirement of scienter.¹⁶³

The above analysis indicates that the disjunctive prohibitions of section 10(b) refer to dissimilar kinds of conduct, with varied levels of scienter. While a "manipulative contrivance" very arguably connotes conduct involving scienter, a "deceptive device" has potentially neutral connotations, and could refer to entirely innocent acts. The Court in *Aaron* and *Hochfelder*, however, read the disjunctive proscriptions of section 10(b) together to establish a uniform scienter requirement under that provision. This approach differs sharply from the *Aaron* Court's analysis of section 17(a) of the 1933 Act. There the Court refused to adopt a uniform culpability standard under the three subparagraphs of that provision because "the language of the section is not amenable to such an interpretation."¹⁶⁴ The Court took pains to note that "each subparagraph of § 17(a) proscribes a distinct category of misconduct."¹⁶⁵ This reasoning would seem equally applicable to the varied prohibitions of section 10(b). Having taken such care in separating the prohibitions of section 17(a), it was inconsistent for the Court not to have distinguished a "deceptive device" from a "manipulative contrivance."

Of course, the Court's failure to analyze the text of sections 10(b) and 17(a) in a similar fashion may be explained by the different manner in which the two statutes were drafted. The prohibitions of section 17(a) are laid out in discrete subparagraphs,¹⁶⁶ while those of section 10(b) are grouped together in one phrase.¹⁶⁷ When taken together, however, the prohibitions of section 10(b) cannot fairly be accorded a uniform scienter standard. To read the prohibitions together requires acknowledging their collective ambiguity. Indeed, it is doubtful that Congress intended to incorporate any specific standard of culpability under section 10(b). In the express liability provisions of the 1933 and 1934 Acts,

¹⁶¹ See WEBSTER'S NEW INTERNATIONAL DICTIONARY 1937 (1933).

¹⁶² "Manipulate" was defined in 1934 as "[t]o treat or manage with the mind or intellect. To control the action of, by management; as, to *manipulate* a convention; also, to manage or treat artfully or fraudulently; as, to *manipulate* accounts, or election returns." WEBSTER'S INTERNATIONAL DICTIONARY 1496 (2d ed. 1934).

¹⁶³ See, e.g., *Gold Seal Co. v. Weeks*, 129 F. Supp. 928, 934 (D.D.C. 1955) (construing "deceptive" in a federal trademark statute as not requiring a showing of scienter, only a showing of a material misrepresentation reasonably relied upon by purchaser); *People v. Wahl*, 3 Cal. App. Supp. 196, 197, 100 P.2d 550, 551 (1940) (construing "deceptive" in a state false-advertising statute as "not always imply[ing] intent to deceive." See also Sonde & Freedman, "Seagulls on the Water — Some Ships in a Storm": A Comment on *Lanza v. Drexel*, 49 N.Y.U. L. REV. 270, 290 (1974) (focusing on the effect-oriented connotations of "deceptive").

¹⁶⁴ 446 U.S. at 697.

¹⁶⁵ *Id.*

¹⁶⁶ See note 14 *supra* for the text of § 17(a).

¹⁶⁷ See note 11 *supra* for the text of § 10(b).

Congress used expressions such as "reasonable ground to believe,"¹⁶⁸ "for the purpose,"¹⁶⁹ "had no knowledge,"¹⁷⁰ and "knew"¹⁷¹ to describe conscious or intentional wrongdoing. A negligence standard was imposed through such phrases as "reasonable care"¹⁷² and "reasonable investigation."¹⁷³ Congress never employed the terms "manipulative" or "deceptive" when establishing culpability standards under a statute providing for express civil liability.

In spite of the latent ambiguity of the operative terms of the statute and scant evidence of Congressional intent in drafting the provision, the *Aaron* Court was content to resolve the issue of scienter under section 10(b) by relying on a prior case which had ascertained the meaning of that provision primarily by reference to the dictionary definitions of its terms.¹⁷⁴ A more appropriate approach to resolving the issue would be to frankly acknowledge the ambiguity of the phrase "manipulative or deceptive device or contrivance" and proceed to determine the appropriateness of a scienter requirement by an examination of legislative history, the common law requirements for relief from fraud, and the legislative policy and statutory scheme of the 1934 Act.

Despite its asserted confidence in the plain meaning of section 10(b), the Court in *Hochfelder* found broader justification of its holding in the legislative history of that section.¹⁷⁵ The Court remarked that the extensive hearings preceding the passage of the 1934 Act "touched only briefly on § 10."¹⁷⁶ Nevertheless, it emphasized as "[t]he most relevant exposition of the provision that was to become § 10(b)" a statement by a spokesman for the drafters, Thomas G. Corcoran.¹⁷⁷ Corcoran had described the provision's function as a "catch-all clause to prevent manipulative devices."¹⁷⁸ The Court found it "difficult to believe" that any legislative draftsman would use those words to describe a provision intended to prohibit merely negligent conduct.¹⁷⁹ In addition, although the committee reports had not directly considered the scope of section 10(b), the Court found their discussion of specific manipulative practices proscribed by other sections of the 1934 Act to indicate an overall congressional intent to attach civil liability only to intentional conduct.¹⁸⁰ While aware of the inadequacy of the historical evidence, the Court in *Hochfelder* was satisfied that

¹⁶⁸ See Securities Exchange Act of 1934, § 9(a)(4), 15 U.S.C. § 78i(a)(4) (1976).

¹⁶⁹ See Securities Exchange Act of 1934, § 9(a)(1), (2), (4), (6), 15 U.S.C. § 78(a)(1), (2), (4), (6) (1976).

¹⁷⁰ See Securities Act of 1933, § 15, 15 U.S.C. § 77o (1976). Congress used the negative construction "had no knowledge" in section 15 to provide that controlling persons will be jointly liable with those they control unless such controlling person "had no knowledge" of the facts on which the alleged liability of the controlling person is based. *Id.*

¹⁷¹ See Securities Exchange Act of 1934, § 9(a)(4), 15 U.S.C. § 78i(a)(4) (1976).

¹⁷² See Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1976).

¹⁷³ See Securities Act of 1933, § 11(b)(3)(B), 15 U.S.C. § 77k(b)(3)(B) (1976).

¹⁷⁴ 446 U.S. at 689-95.

¹⁷⁵ 425 U.S. at 201-06.

¹⁷⁶ *Id.* at 202.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* (quoting *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934)).

¹⁷⁹ 425 U.S. at 203.

¹⁸⁰ *Id.* at 205.

"[t]here is no indication . . . that § 10(b) was intended to proscribe conduct not involving scienter."¹⁸¹

The legislative history of section 10(b), discussed by the Court in *Hochfelder* and *Aaron* and acknowledged to be ambiguous,¹⁸² offers no independent support for a scienter requirement under that provision. Rather, the *Hochfelder* reasoning followed in *Aaron*, was that the language of section 10(b) raised a presumption of a scienter requirement, which the meager historical evidence of congressional intent failed to rebut.¹⁸³ Only in this limited context was the Court able to say that "history support[s] our conclusion that § 10(b) was addressed to practices involving some element of scienter."¹⁸⁴ The validity of even this limited conclusion, however, is debatable because the hearings and reports cited in *Hochfelder* and *Aaron* as indirect support for a scienter requirement under section 10(b) referred to earlier drafts of section 10(b) that did not contain the term "deceptive."¹⁸⁵ Since "deceptive" has a broader meaning than "manipulative,"¹⁸⁶ reliance on these reports would seem unfounded.

The *Aaron* Court appeared to recognize the inadequacy of legislative history as independent support for its holding when it insisted that "the language of the statute . . . was sufficient, standing alone, to support the [*Hochfelder*] Court's conclusion that scienter is required in a private damage action under § 10(b)."¹⁸⁷ The *Aaron* Court's reasoning thus amounted to the mere assertion that *Hochfelder*'s confidence in the plain meaning of the language of section 10(b) should apply with equal force to SEC injunctive suits under that provision.¹⁸⁸

The foregoing analysis has demonstrated the inadequacy of *Aaron*'s reasoning. Neither the language nor the legislative history of section 10(b) clearly reveal what state of mind requirement Congress intended for injunctive actions under that provision. Accordingly, an analysis of the meaning of section 10(b) in the context of injunctive relief should properly have focused on the common law setting for the securities laws, the statutory scheme, administrative interpretation, and policy considerations.¹⁸⁹

¹⁸¹ *Id.* at 202.

¹⁸² See 446 U.S. at 690; 425 U.S. at 201, 202.

¹⁸³ In *Hochfelder*, after analyzing the language of § 10(b), which the Court found "strongly suggest[ed] that § 10(b) was intended to proscribe knowing or intentional misconduct," 425 U.S. at 197, the Court stated that "further inquiry may be unnecessary." *Id.* at 201. The Court examined the legislative history not to provide additional support for its textual analysis, but only "to ascertain whether there is support for the meaning attributed to § 10(b) by the Commission [in its *amicus curiae* brief] and respondents." *Id.* (both argued for a negligence standard under § 10(b)).

¹⁸⁴ *Id.* at 201.

¹⁸⁵ The Court relied on a statement by Thomas G. Corcoran, a spokesman for the drafters of the provision that was to become section 10(b), to determine the scope of that provision. *Id.* at 202. The statement, however, concerned H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. (1934), drafts of § 10(b) that lacked the term "deceptive." Similarly, the Senate Report, S. REP. NO. 792, 73d Cong., 2d Sess. (1934), also relied upon by the Court to establish the scope of § 10(b) analyzed S. 3420, 73d Cong., 2d Sess. (1934), a draft of § 10(b) that also did not contain the term "deceptive." See Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder*, 77 COLUM. L. REV. 419, 426 & n.46 (1977).

¹⁸⁶ See text and note at note 163 *supra*.

¹⁸⁷ 446 U.S. at 691 n.9.

¹⁸⁸ *Id.* at 691.

¹⁸⁹ The Supreme Court followed a similar approach in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The *Blue Chip* Court rejected a restrictive analysis, akin to that

B. *The Applicability of the Doctrine of Equitable Fraud to SEC Injunctive Actions*

After concluding that *Hochfelder* required proof of scienter in Commission injunctive actions under section 10(b), the Court in *Aaron* then rejected the relevance of *SEC v. Capital Gains Research Bureau*¹⁹⁰ to the instant case.¹⁹¹ This rejection of *Capital Gains* ignored the significance of the common law setting in which the securities laws were enacted. *Capital Gains* presented the issue whether the SEC is required to establish scienter to enjoin deceptive conduct proscribed by section 206(2) of the Investment Advisors Act of 1940.¹⁹² The Court held that proof of scienter was not required, grounding its conclusion on evidence of legislative intent,¹⁹³ the requirements for relief from fraud under the common law,¹⁹⁴ and the practical effect of a scienter requirement on achieving the purposes of the legislation.¹⁹⁵ Although the legislative history of section 206(2) offered adequate grounds for its holding,¹⁹⁶ the Court nevertheless analyzed the implications of the common law tradition where the requirements for relief from fraud vary with the nature of the transaction, the relationship of the parties, and the type of relief requested.¹⁹⁷ It stressed that in a suit for equitable relief, proof of scienter was generally not required.¹⁹⁸ Unwilling to assume Congress was not aware of these developments in the common law, the Court in *Capital Gains* suggested that the legislation had incorporated these flexible standards for relief.¹⁹⁹

The *Aaron* Court distinguished *Capital Gains* on the grounds that the language and legislative history of section 206(2) did not support a scienter requirement,²⁰⁰ and that the provision regulated a fiduciary relationship, wherein "intent to defraud would not have been required even in a common-law action for money damages."²⁰¹ While these observations may have undercut the precedential value of *Capital Gains* in the context of Commission injunc-

employed in *Hochfelder* and *Aaron*, which would rely primarily on linguistic analysis and historical evidence. "We would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under rule 10b-5." *Id.* at 737. With regard to the proper weight to be accorded historical evidence of legislative intent, the Court stated:

[I]t would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

Id.

¹⁹⁰ 375 U.S. 180 (1963).

¹⁹¹ 446 U.S. at 691-95.

¹⁹² 375 U.S. at 185-86. See note 87 *supra* for the text of § 206(2) and the type of conduct ("scalping") sought to be enjoined.

¹⁹³ 375 U.S. at 186-92.

¹⁹⁴ *Id.* at 192-95.

¹⁹⁵ *Id.* at 200-01.

¹⁹⁶ *Id.* at 192.

¹⁹⁷ *Id.* at 193.

¹⁹⁸ *Id.* See note 92 *supra*.

¹⁹⁹ *Id.* at 195.

²⁰⁰ 446 U.S. at 694.

²⁰¹ *Id.*

tive actions under section 10(b), they do not weaken the relevance of the common law tradition on which the Court in *Capital Gains* relied. It is submitted that this common law tradition along with congressional reliance on state predecessors to the federal securities laws is persuasive evidence that Congress intended the SEC to have equitable enforcement power under section 10(b) absent a showing of scienter.

1. The Common Law Background

When Congress enacted the federal securities laws, the common law provided a two-tier system of remedies for misrepresentation. Although actions brought to recover damages for misrepresentation required proof of scienter,²⁰² equity provided relief²⁰³ for defrauded plaintiffs without requiring proof of scienter.²⁰⁴ The different nature of the remedies accounted for this two-tier scheme. legal remedies for fraud "center about redress, vindication, punishment, [and] restitution."²⁰⁵ Consequently, courts required a showing of fault before legal remedies could be invoked. Equitable remedies, in contrast, seek to prevent or minimize injury, rather than punish a defendant for his state of mind. "It is not the *cause* but the *fact*, of injury, and the problem of its practical control . . . which concern the [equity] court."²⁰⁶ Further, equitable remedies subjected the defendant to less harm than an action for damages.²⁰⁷ The lower culpability standard for equitable actions thus permitted effective control of fraudulent conduct and at the same time avoided unfairness to defendants. The Court in *Capital Gains* demonstrated a proper concern for harmonizing the requirements for injunctive relief under the federal securities laws with the requirements for equitable relief at common law. Absent clear historical evidence, it should not be presumed that Congress in enacting the 1933 and 1934 Acts intended to depart from the common law tradition.²⁰⁸ Rather, it would be more reasonable to conclude that Congress, consistent with this tradition, intended a two-tier

²⁰² See, e.g., *Derry v. Peek*, 14 App. Cas. 337, 374 (1889) (Lord Herschell holding, in a securities fraud context, that a private damage action based on negligent misrepresentations would not lie). See also 3 RESTATEMENT OF TORTS § 525-526 (1938); F. HARPER, *THE LAW OF TORTS* § 76 (1933).

²⁰³ Rescission of the transaction was the primary equitable remedy for misrepresentation. See generally Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 231-32 (1933).

²⁰⁴ See, e.g., *Bloomquist v. Farson*, 222 N.Y. 375, 380, 118 N.E. 855, 856 (1918); 2 J. POMEROY, *EQUITY JURISPRUDENCE* § 885 (4th ed. 1918).

²⁰⁵ F. LAWRENCE, *SUBSTANTIVE LAW OF EQUITY JURISPRUDENCE* § 13 (1929).

²⁰⁶ *Id.*

²⁰⁷ The primary equitable remedy for misrepresentation was rescission of the transaction. This remedy merely restored the parties to the status quo before the sale. Thus, "it does not seem that a liability for loss is imposed upon the seller, or that money is being taken from his pocket to compensate the buyer." Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 231 (1933). In contrast to the comparative mildness of an equitable action for rescission, an action at law for deceit carried with it the potential of draconian liability. Also, the charge of deceit was considered to be in effect an accusation of thievery, and considerable social opprobrium attached to a determination of liability. *Id.* at 233.

²⁰⁸ The Court in *Hecht Co. v. Bowles*, 321 U.S. 321 (1944), adopted this exact reasoning: "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." *Id.* at 330.

standard for relief under section 10(b), with proof of scienter required in a private suit for damages, but not in an equitable injunctive action.

2. Congressional Reliance on State Blue Sky Statutes

The significance of this common law tradition of broad equitable relief against fraud is buttressed by reference to state precursors of the federal securities laws. Prior to the passage of the federal securities laws, many states had attempted to deal with the problem of securities fraud by enacting their own "blue sky" statutes. One variety of these state statutes empowered governmental authorities to enjoin fraudulent practices in the sale of securities.²⁰⁹ Congress, in seeking to provide federal securities regulation explicitly drew from the experience of the states.²¹⁰ Conspicuous among these state statutes was New York's Martin Act,²¹¹ which had been actively enforced.²¹² Congress used the Martin Act as one of its principal models in drafting the Securities Act of 1933.²¹³ It is not surprising, therefore, that the Martin Act's anti-fraud provisions closely resembled section 17(a)(1) and (3) of the 1933 Act,²¹⁴ and the Martin Act's provision authorizing government injunctive actions was almost identical to section 20(b) of the 1933 Act.²¹⁵ The New York statute was also cited during the congressional debates to explain the injunctive provisions under the 1934 Act.²¹⁶ In light of Congress's reliance on the Martin Act in drafting those provisions under consideration by the *Aaron* Court, the judicial construction of the Martin Act by the New York courts would appear to be highly relevant in ascertaining a congressional intent to impose a scienter requirement under section 17(a) and section 10(b). In this regard, it is significant that the New York Court of Appeals in *People v. Federated Radio Corp.*²¹⁷ held that securities fraud could be enjoined in equity under the statute without proof of scienter.²¹⁸ Further, the New York

²⁰⁹ See 1 L. LOSS, *supra* note 6, at 30-32, 35-43 (1961); L. LOSS & E. COWETT, *BLUE SKY LAW* at 17-26 (1958).

²¹⁰ 446 U.S. at 711 (Blackmun, J., dissenting).

²¹¹ 1921 N.Y. Laws c. 649 §§ 352-353.

²¹² See McCall, *Comments on the Martin Act*, 3 BROOKLYN L. REV. 190, 203 (1934) (2,682 individuals and corporations enjoined between 1931 and 1933).

²¹³ 446 U.S. at 711 (Blackmun, J., dissenting). See, e.g., *Federal Securities Act, Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 1st Sess., 11, 95, 109, 112 (1933); *Securities Act: Hearings on S. 875 before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess., 71, 146, 147, 156, 170, 245-46, 253. See generally 1 LOSS, *supra* note 6, at 33-34, 35-43.

²¹⁴ Compare 1921 N.Y. Laws c. 649 § 352 with § 17(a)(1) and (3) of the Securities Act of 1933, 15 U.S.C. § 77q(a)(1) and (3) (1976).

²¹⁵ Compare 1921 N.Y. Laws c. 649 § 353 with § 20(b) of the Securities Act, 15 U.S.C. § 77t(b) (1976).

²¹⁶ See 78 CONG. REC. 8096 (1934) (remark of Rep. Black).

²¹⁷ 244 N.Y. 33, 154 N.E. 655 (1926).

²¹⁸ *Id.* at 38-39, 41, 154 N.E. at 657, 658. Professor Loss described *Federated Radio* as "one of the leading cases on the concept of fraud in securities legislation, state or federal." 1 LOSS, *supra* note 4, at 41 n.78.

Federated Radio's holding that proof of scienter was not required in injunctive proceedings to enjoin securities fraud was repeatedly upheld by the New York courts. See, e.g., *People v. Rice*, 221 App. Div. 443, 447-48, 223 N.Y.S. 566, 570-71 (1927); *People v. New York City Air Port, Inc.*, 143 Misc. 472, 473, 256 N.Y.S. 89, 90-91 (1931).

decision "was in keeping with the general tenor of state laws governing equitable relief in the context of securities transactions."²¹⁹

Although the *Aaron* Court was aware that Congress had relied on the Martin Act to the extent of incorporating some of its language into the 1933 and 1934 Acts, it dismissed the significance of the New York Court's construction of the statute because there was no evidence that the holding of *Federated Radio* was specifically called to Congress's attention.²²⁰ It seems unwarranted, however, to demand proof of congressional cognizance of a particular holding in this context. If Congress went so far as to adopt the language of the Martin Act, it seems that it would have also been aware of the construction given its important provisions by the highest New York Court. Moreover, *Federated Radio* was not an isolated holding.²²¹ Rather, it was part of an established and longstanding equity tradition.²²² If Congress had intended to depart from this tradition in enacting the securities laws, it would have left more evidence of that intention than the *Aaron* Court was able to find.

C. *Harmonizing the State of Mind Requirement Under Section 10(b)*
with the Statutory Array of SEC Remedies

In addition to its failure to harmonize statutory construction with prevailing equity practice at the time the securities laws were enacted, the *Aaron* Court also failed to consider the impact of its holding on the carefully balanced statutory array of SEC enforcement remedies. In this respect, the Court departed from the reasoning of *Hochfelder*. Indeed, perhaps the strongest support for the Court's reading of section 10(b) in *Hochfelder* was its reasoning that the scheme of civil liability in the 1933 and 1934 Acts requires proof of scienter for the recovery of damages under that provision.²²³ The *Hochfelder* Court was concerned that extending the scope of section 10(b) to permit private damage actions predicated on negligence would "nullify the effectiveness of the carefully drawn procedural restrictions" on the express civil remedies in the 1933 Act allowing recovery for negligent conduct.²²⁴ A similar concern for the statutory scheme should have guided the *Aaron* Court's construction of section 10(b). A negligence standard for injunctive relief would entail no comparable

²¹⁹ *Aaron v. SEC*, 446 U.S. at 712 (Blackmun, J. dissenting). Contemporary legal commentary on blue sky statutes noted that injunctive relief was available without proof of defendant's scienter. See Note, *Liability for Misrepresentations in Corporate Prospectuses*, 40 YALE L.J. 987, 987 (1931).

²²⁰ 446 U.S. at 700 n.18.

²²¹ *Id.* at 712 (Blackmun, J., dissenting). See note 218 *supra*.

²²² 446 U.S. at 712 (Blackmun, J., dissenting).

²²³ 425 U.S. at 208-11.

²²⁴ *Id.* at 210. The Court observed that "[e]ach of the provisions of the 1934 Act that expressly create civil liability, except those directed at specific classes of individuals such as directors, officers, or 10% beneficial holders of securities, see § 16(b), 15 U.S.C. § 78p(b) . . . contains a state-of-mind condition requiring something more than negligence." *Id.* at 209 n.28 (citations omitted). The Court did note, however, that "some courts have concluded that proof of scienter is unnecessary in an action for damages [under § 14(a) of the 1934 Act, 15 U.S.C. § 78n(a)] by the shareholder recipients of a materially misleading proxy statement against the issuer corporation." 425 U.S. 209 n.28. See note 78 *supra* for a discussion of the procedural restrictions on actions brought under §§ 11, 12(2), and 15 of the 1933 Act.

nullification of procedural limitations in the 1933 or 1934 Act, and indeed, would harmonize the state of mind requirements in the statutory array of SEC remedies.

The options available to the SEC in enforcing the securities laws include administrative sanctions, criminal referrals to the Justice Department, and injunctive proceedings. Certain provisions of the securities laws permit the SEC to impose administrative sanctions on persons who "willfully" violate the statutes.²²⁵ The governmental remedy may have severe consequences for the defendant. If the SEC determines that a sanction is in the public interest, it may revoke, suspend, or deny registration of a broker-dealer²²⁶ or investment adviser²²⁷ or censure or limit the activity of anyone associated with a broker-dealer.²²⁸ An additional remedy consists of referring cases of willful violations to the Justice Department with a recommendation for criminal prosecution.²²⁹ If the action is pursued by the Justice Department, the defendant may be subject to both fines and imprisonment.²³⁰ The provisions of the 1933 and 1934 Acts authorizing the SEC to seek injunctive relief, however, to not impose a state of mind requirement. Rather, section 20(b) of the 1933 Act and section 21(d) of the 1934 Act require a district court to grant injunctive relief "upon a proper showing."²³¹ Since Congress did not specify a state of mind requirement under these provisions, reference to the other statutory remedies available to the Commission and the express culpability standards thereunder is appropriate in determining what constitutes a "proper showing" under sections 20(b) and 21(d).

Congress reserved the more severe remedies of administrative sanctions and criminal prosecution for "willful" violations of the securities laws. Since knowing and intentional misconduct is already subject to these punitive remedies, a relaxed state of mind requirement for Commission injunctions, which serve to protect rather than to punish, would harmonize the statutory scheme. It is logical to assume that Congress intended the statutory injunction to protect against a broader range of conduct than that which is criminal.

The overlapping coverage of section 10(b) and section 17(a) of the 1933 Act also suggests that section 10(b) should be read to encompass more than

²²⁵ See Securities Exchange Act of 1934, §§ 8(a), 15(b)(4)(A), (D), & (E), and 15(b)(7), 15 U.S.C. §§ 78h(a), 78o(b)(4)(A), (D), & (E) (1976); Investment Advisers Act of 1940, §§ 203(d)(1) and (4), 203(f), 15 U.S.C. §§ 80b-3(e)(1), (4) & (5), 80b-3(f) (1976).

²²⁶ Securities Exchange Act of 1934, § 15(b)(5), 15 U.S.C. § 78o(b)(4) (1976).

²²⁷ Investment Advisers Act of 1940, § 203(d), 15 U.S.C. § 80b-3(e) (1976).

²²⁸ Securities Exchange Act of 1934, § 15(b), 15 U.S.C. § 78o(b)(6) (1976).

²²⁹ See, e.g., Securities Act of 1933, § 20, 15 U.S.C. § 77t(b) (1976); Securities Exchange Act of 1934, § 32, 15 U.S.C. § 78ff (1976). While it is unnecessary to prove that defendant had the specific intent to violate the law, it must be shown that defendant understood his actions and purposefully performed the acts constituting the violation. See generally James, *Culpability Predicates for Federal Securities Law Sanctions: The Present Law and the Proposed Federal Securities Code*, 12 HARV. J. LEGIS. 1 (1974).

²³⁰ See, e.g., Securities Act of 1933, § 24, 15 U.S.C. § 77x (1976) (\$10,000 fine and/or five years imprisonment); Securities Exchange Act of 1934, § 32, 15 U.S.C. § 78ff (1976) (maximum fine of \$500,00 for an exchange; \$10,000 fine and/or 5 years imprisonment for others).

²³¹ Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1976); Securities Exchange Act of 1934, § 21(d), 15 U.S.C. § 78u(d) (1976). See note 28 *supra* for text of provisions.

intentional conduct when enforced by Commission injunctions. Section 17(a) prohibits misrepresentations made by sellers of securities.²³² Section 10(b) covers misrepresentations made by either a buyer or a seller.²³³ Under *Aaron*, proof of scienter is required under section 17(a)(1), but not under section 17(a)(2) and (3).²³⁴ It appears, however, that the Court's ruling would not diminish to any appreciable extent the power of the SEC to enjoin deceptive practices in the offer or sale of securities. The reason for this is the overlapping coverage of the three subparagraphs of section 17(a).²³⁵ Subparagraph (1) prohibits employing "any device, scheme, or artifice to defraud" "in the offer or sale of any securities," and requires proof of scienter to establish an enjoined violation.²³⁶ Subparagraph (2) prohibits obtaining "money or property by means of any untrue statement of a material fact or any omission to state a material fact," and, under *Aaron* does not require proof of scienter.²³⁷ Subparagraph (2) would appear to prohibit devices and schemes to defraud subject to sanction under subparagraph (1) to the extent such devices to defraud involved material misstatements or omissions for pecuniary gain. Where no statement or omission was involved, or where no pecuniary gain resulted, however, conduct prohibited by subparagraph (1) could not be enjoined under subparagraph (2). What might be left of the independent coverage of subparagraph (1), however, appears to be fully subsumed by the broad sweep of the prohibitions of subparagraph (3), which also does not require proof of scienter.²³⁸ Subparagraph (3) makes unlawful "any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." The provision, which focuses solely upon the effect of deceptive practices upon the purchaser, does not require any material statement or omission to be made by the offeror or seller of a security, nor does it require any pecuniary gain to accrue to the perpetrator of the deception. Thus, both barriers to liability under subparagraph (2) would be avoided if the SEC proceeded under subparagraph (3). Furthermore, the prohibition of devices, schemes, or artifices to defraud under subparagraph (1) would appear to fall entirely within the larger class of prohibitions under subparagraph (3) of "practices" which "operate" as a fraud or deceit. Under subparagraph (3), an actual fraud need not be shown, but only a course of conduct which has the effect of defrauding a purchaser. Additionally, subparagraph (3) covers any *practice* which has the proscribed effect, while subparagraph (1) is limited to devices, schemes, and artifices. The *Aaron* Court determined that subparagraph (1) conduct must

²³² Section 17(a) applies only to misrepresentations made "in the offer or sale of any securities." The text of § 17(a), 15 U.S.C. § 77q(a) (1976), is set out in note 14 *supra*.

²³³ Section 10(b) prohibits misrepresentations made "in connection with the purchase or sale" of any security. The text of § 10(b), 15 U.S.C. § 78j(b) (1976), is set forth in note 11 *supra*. The "in connection with" language has been construed to extend the ambit of § 10(b) beyond misrepresentations made in transactions, and has been held to cover misleading corporate releases. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied sub nom. Kline v. SEC*, 394 U.S. 976 (1969).

²³⁴ *Aaron v. SEC*, 446 U.S. at 701-02.

²³⁵ See note 14 *supra* for the text of § 17(a).

²³⁶ 446 U.S. at 701.

²³⁷ *Id.* at 702.

²³⁸ *Id.*

involve scienter. In contrast, a "practice" merely denotes an action or deed and is not limited to intentional misconduct.²³⁹ It would therefore appear that by holding section 17(a)(1) to require proof of scienter, the *Aaron* Court did little to restrict the Commission's power to enjoin deceptive practices in the offer or sale of securities. The broad scope of subparagraphs (2) and (3) renders the scienter standard under subparagraph (1) effete. Consequently, section 17(a) as a whole is not limited by a scienter requirement.

In view of the overlapping coverage of the three subparagraphs of section 17(a), the effect of the Court's holding section 10(b) to require proof of scienter is to disrupt the statutory scheme of the 1933 and 1934 Acts. To require proof of scienter under section 10(b), which applies to both purchasers and sellers, but not under section 17(a), which applies only to sellers, is to state that "henceforth only the seller's negligent misrepresentations may be enjoined."²⁴⁰ Neither the language of section 10(b) nor the policies of the 1933 and 1934 Acts support this distinction.²⁴¹ An identical standard of liability under section 17(a) and 10(b) would harmonize the statutory scheme.

D. Judicial Deference to Administrative Construction Which Has Been Approved by Congress

Prior to *Aaron*, the SEC had long maintained that section 10(b) and rule 10b-5 did not require proof of scienter when enforced by Commission injunctions.²⁴² As a general rule, courts defer to the construction placed on a statute by the agency charged with its execution²⁴³ unless that construction is "inconsistent with a statutory mandate or [would] frustrate the congressional policy underlying a statute."²⁴⁴ The administrative construction of a statute is accorded even greater weight when Congress reviews and approves that construction in the course of amending or re-enacting the statute.²⁴⁵ It is submitted that the SEC's

²³⁹ See WEBSTER'S NEW INTERNATIONAL DICTIONARY 1937 (1933).

²⁴⁰ 446 U.S. at 715, (Blackmun, J., dissenting).

²⁴¹ The legislative purposes of (1) providing "full and fair disclosure of the character of securities sold in interstate and foreign commerce," H.R. REP. NO. 85, 73d Cong., 1st Sess. 1 (1933); (2) banning deceptive, misleading, or fraudulent practices, S. REP. NO. 47, 73d Cong. 1st Sess. 1 (1933); (3) restoring public confidence in the securities industry, H.R. REP. NO. 1383, 73d Cong., 2d Sess. 5 (1934); and (4) preventing the further wasting of national resources caused by disreputable business practices, H.R. REP. NO. 85, 73d Cong., 1st Sess. 2-3 (1933), are not promoted by permitting the SEC to enjoin negligent misrepresentations by sellers but not by purchasers. See Note, *Injunctive Relief in SEC Civil Actions: The Scope of Judicial Discretion*, 10 COLUM. J. L. & SOC. PROB. 328, 332-35 (1974) [hereinafter cited as COLUMBIA NOTE].

²⁴² Brief for SEC at 53-54, *Aaron v. SEC*, 446 U.S. 680 (1980).

²⁴³ See, e.g., *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381 (1969).

²⁴⁴ *SEC v. Sloan*, 436 U.S. 103, 118 (1978).

²⁴⁵ See, e.g., *Andrus v. Allard*, 444 U.S. 51, 57 (1979) ("it is particularly relevant that Congress has twice reviewed and amended the statute without rejecting the Department's view"); *United States v. Rutherford*, 442 U.S. 544, 553-54 & n.10 (1979) ("once an agency's statutory construction has been fully brought to the attention of the public and Congress, and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned"); *Lorillard v. Pons*, 434 U.S. 575, 580 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change"); *Saxbe v.*

interpretation of section 10(b) and rule 10b-5 as not requiring proof of scienter was in accord with the policies underlying the 1933 and 1934 Acts and was not inconsistent with the statutory language of section 10(b). Furthermore, Congress was expressly informed of the Commission's position on two occasions when significant amendments to the securities laws were enacted. On each occasion Congress left the administrative interpretation undisturbed.

Congress considered the requirements for Commission injunctions in the course of passing the Securities Act Amendments of 1975.²⁴⁶ The Senate report of the bill ultimately enacted addressed the purpose and scope of Commission injunctive remedies and noted that proof of scienter was not required in such actions.²⁴⁷ In reliance on the different purposes of Commission enforcement proceedings and private actions,²⁴⁸ Congress enacted section 21(g) of the 1934 Act which provides that, absent consent from the Commission, private actions may not be consolidated with Commission proceedings.²⁴⁹ Prior law had provided for consolidation of actions involving common questions of fact.²⁵⁰ Under this procedure, private litigants frequently attempted to "ride along on the Government's cases."²⁵¹ The committee found that consolidation substantially delayed the Commission's attempts to secure prompt relief from violations of the securities laws.²⁵² The report noted that one of the chief causes of delay was that private actions raise issues, such as defendant's scienter, that need not be proven in a Commission injunctive action.²⁵³

Congress again reviewed the Commission's interpretation that scienter is not required in injunctive actions when enacting the Foreign Corrupt Practices

Bustos, 419 U.S. 65, 74 (1974) ("[s]uch a history of administrative construction and congressional acquiescence may add a gloss or qualification to what is on its face unqualified statutory language").

²⁴⁶ Pub. L. No. 94-29, 89 Stat. 97 (1975).

²⁴⁷ S. REP. NO. 94-75, 94th Cong., 1st Sess. 76-77, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 179, 254-55.

²⁴⁸ The Senate Committee on Housing, Banking, and Urban Affairs stated:

[A]lthough both the Commission's suit for injunctive relief brought pursuant to express statutory authority and a private action for damages fall within the general category of civil (as distinct from criminal) proceedings, their objectives are really quite different. Private actions for damages seek to adjudicate a private controversy between citizens; the Commission's action for civil injunction is a vital part of the Congressionally [sic] mandated scheme of law enforcement in the securities area. *Id.* at 76, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS at 254.

²⁴⁹ 15 U.S.C. § 78u(g) (1976).

²⁵⁰ 28 U.S.C. § 1407, enacted by Congress in 1968, created a procedure for consolidated or coordinated pre-trial proceedings for litigation in which two or more actions involving one or more common questions of fact were pending in jurisdictional districts. *See* S. REP. NO. 94-75, 94th Cong., 1st Sess. 73-76, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 179, 251-54, for a discussion of the prior law and the Commission's experience with the consolidation provision.

²⁵¹ S. REP. NO. 94-75, 94th Cong., 1st Sess. 74, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS at 252.

²⁵² *Id.* at 74, 76, 77, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS at 252, 254, 255.

²⁵³ *Id.* at 76, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS at 254. The Senate report stated: "Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to . . . scienter, causation, and the extent of damages are elements *not* required to be demonstrated in a Commission injunctive action." *Id.* (emphasis in original).

Act of 1977.²⁵⁴ The House bill prohibited certain corrupt foreign payments by domestic corporations.²⁵⁵ Civil and criminal sanctions were provided, and the SEC and the Justice Department were granted concurrent enforcement jurisdiction.²⁵⁶ Although criminal prosecution required proof of intent, the House bill did not specify whether a similar burden applied to Commission injunctive proceedings. The House report, however, emphasized that it did not intend a scienter requirement.²⁵⁷ Reasoning that "an SEC enforcement action is designed to protect the public against the recurrence of violative conduct, and not to punish a state of mind,"²⁵⁸ the report expressly approved judicial decisions holding that scienter was not required when the SEC seeks injunctive relief under rule 10b-5.²⁵⁹

The *Aaron* Court summarily dismissed the relevance of this congressional endorsement of the Commission's interpretation of section 10(b) with the observation that "the legislative consideration of those statutes was addressed principally to matters other than at issue here."²⁶⁰ The Commission's interpretation of section 10(b) however, was compatible with the text and purpose²⁶¹ of the 1934 Act and enjoyed sufficient congressional approval to be accorded a presumption of validity.²⁶² The *Aaron* Court ignored established principles of judicial deference to administrative interpretation in proceeding directly to the dictionary definition of the operative terms of section 10(b).

E. Policy Considerations

The ambiguous text and legislative history of section 10(b), the affirmation of the distinction between fraud at law and fraud in equity in the securities laws, and subsequent congressional approval of this two-tier scheme of culpability standards should have convinced the *Aaron* Court that *Hochfelder* did not require a scienter standard for Commission injunctive enforcement of section 10(b). When analysis of statutory text and historical evidence does not clearly reveal legislative intent, it is proper for courts to construe provisions in a manner con-

²⁵⁴ Pub. L. No. 95-213, 91 Stat. 1494 (1977).

²⁵⁵ H.R. REP. NO. 95-640, 95th Cong., 1st Sess. 4 (1977).

²⁵⁶ *Id.* at 9-10.

²⁵⁷ *Id.* at 10.

²⁵⁸ *Id.*

²⁵⁹ *Id.* The report stated:

Although the Supreme Court has held that private plaintiffs seeking to recover monetary damages for violations of Securities Exchange Act Rule 10b-5 . . . must establish that the defendant acted with *scienter*, the appellate courts quite properly have never required proof of *scienter* in any of the Commissions's own enforcement proceedings . . . [T]his committee intends that *scienter* is not an element of any Commission enforcement proceeding.

Id. (citations omitted; emphasis in original). The weight to be accorded these statements in the House Committee Report should not be over-estimated. First, the Senate bill, S. 305, rather than the House bill, H.R. 3815, became law. Secondly, the Conference Committee stated that "this legislation should not be converted into a debate on the important issues raised by the *Hochfelder* decision." H.R. CONF. REP. NO. 95-381, 95th Cong., 1st Sess. 11, *reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 4121, 4123.

²⁶⁰ 446 U.S. at 694 n.11.

²⁶¹ See note 241 *supra*.

²⁶² See note 245 *supra*.

sistent with the overall purposes and policies of the legislation.²⁶³ Indeed, the Supreme Court has endorsed the appropriateness of policy considerations when defining the ambit of section 10(b) and rule 10b-5.²⁶⁴ If the *Aaron* Court had made such an inquiry into the purposes served and consequences imposed by the statutory injunction, it is unlikely the Court would have imposed a rigid scienter requirement on injunctive actions to enforce section 10(b).

The rationale for dispensing with proof of scienter in equitable actions at common law lay in a concern for effective enforcement and in the assumption that the relief granted did not impose unfair hardship on defendants.²⁶⁵ A similar approach in the context of the securities laws was adopted in *Capital Gains*,²⁶⁶ and applied to section 10(b) by Judge Friendly in *SEC v. Texas Gulf Sulphur Co.*²⁶⁷ This approach applied the common law doctrine of equitable fraud to Commission actions to enjoin fraudulent conduct. The merits of this approach will be examined to see if a broad culpability standard for SEC injunctive relief would further the policies of the securities laws while not inflicting unreasonable harm.

The primary support for a broader culpability requirement is that it would enable the SEC, as the "statutory guardian" of the public interest,²⁶⁸ to better protect investors. The statutory injunction is a flexible, effective, and speedy means of enforcing compliance with the law.²⁶⁹ In addition to its primary function of safeguarding the public interest by enjoining specific present or future violations, an injunction also serves as an effective deterrent and a useful tool to publicize the scope of the law through "educational litigation."²⁷⁰ The Commission relies heavily on injunctions as a means of enforcing compliance with the securities laws.²⁷¹ Since the harm to investors from deceptive practices is the same whether those practices are intentional or negligent, a relaxed culpability standard would enable the SEC to protect against a broader range of deceptive conduct. In addition, removing the difficult task of proving scienter would reduce the Commission's burden of proof, thus making injunctions easier to obtain. A negligence standard would also increase the Commission's bargain-

²⁶³ See, e.g. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

²⁶⁴ *Id.*

²⁶⁵ See text and notes at notes 202-08 *supra*.

²⁶⁶ 375 U.S. 180, 192-95 (1963).

²⁶⁷ 401 F.2d 833, 866 (2d Cir. 1968) (Friendly, J., concurring). Although Judge Friendly argued that proof of scienter should be required under § 10(b) in the context of private damage actions, *id.* at 866-68, he also asserted that negligence was the appropriate standard for injunctive enforcement of § 10(b). *Id.* at 868. After stating that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for money damages," *id.*, Judge Friendly concluded that the public interest in effective enforcement of the securities laws and the comparative mildness of an injunction's impact on a defendant and his legitimate activities justified a reduced standard of liability for injunctive relief under § 10(b). *Id.*

²⁶⁸ *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2d Cir. 1975).

²⁶⁹ See Note, *The Statutory Injunction as an Enforcement Weapon of Federal Agencies*, 57 YALE L.J. 1023, 1025, 1048 (1948) [hereinafter cited as Yale Note].

²⁷⁰ *Id.* at 1048.

²⁷¹ See *Aaron v. SEC*, 446 U.S. at 704. (Blackmun, J., dissenting); *SEC v. IMC International, Inc.*, 384 F. Supp. 889, 894 (N.D. Tex. 1974), *aff'd without opinion*, 505 F.2d 733 (5th Cir. 1974), *cert. denied sub nom. Evans v. SEC*, 420 U.S. 930 (1975); *Cf. Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (noting that Congress provided the Commission with "an arsenal of flexible enforcement powers").

ing power. Defendants would be more likely to accept consent decrees, thus saving the SEC the time and expense of protracted litigation. Finally, injunctions are perhaps "best suited for application to negligent malfeasors whose future compliance may be stimulated by a judicial mandate."²⁷² Those who are intent on violating the law are less likely to be deterred or prompted to compliance by injunctions.²⁷³ Administrative remedies or criminal prosecution may be better means for ensuring their compliance with the law.

The different functions of Commission injunctions and private damage actions also provide a strong policy basis for according a relaxed standard of proof to injunction proceedings. Whereas the function of a private damage action is to make the injured party whole, and in some instance to punish the wrongdoer,²⁷⁴ Commission actions are brought to safeguard the public interest by enjoining present or future violations.²⁷⁵ Thus, the remedial rather than retributive nature of an injunction action supports a relaxed culpability standard.²⁷⁶ In addition, a negligence standard for SEC injunctive relief would promote the statutory policy of preventing deception in the sale of securities. Injunctions would be more readily obtainable and would protect against a broader range of deceptive conduct under a negligence standard.

Despite such advantages, however, a relaxed standard of liability could create some inequities among defendants and could potentially frustrate other statutory policies. Under a negligence standard, innocent defendants unwilling to undergo the expense and attendant publicity of litigation may be more likely to enter into consent decrees. Moreover, defendants charged with negligent violations may be subject to the same adverse consequences of an injunction or consent decree as would more fiendish violators. In addition, the added protection afforded by a negligence standard would increase the potential for dealer and issuer liability. The cost of increased protective measures employed by dealers would then be passed on to the individual investor. Injunctive liability for negligent acts might also frustrate an important purpose behind the securities laws, the public disclosure of corporate information.²⁷⁷ The spectre of injunctive liability under section 10(b) for negligently prepared press releases might make corporate officials hesitant to issue unnecessary public announcements, thus stifling the full disclosure and exchange of information the securities laws seek to promote.²⁷⁸

²⁷² See Yale Note, *supra* note 269, at 1046-47; SEC v. Spectrum Ltd., 489 F.2d 535 (2d Cir. 1973) (implying that a negligence standard for injunctive enforcement will encourage greater care). *But cf.* SEC v. Universal Major Indus., 546 F.2d 1044, 1047 n.1 (2d Cir. 1976) (entertaining argument that negligence is not enjoicable).

²⁷³ See SEC Civil Injunctive Actions, 30 BUS. LAW. 1303, 1327 (1975) ("If the defendant is a real crook, he couldn't care less about those civil injunctions of the SEC." Remarks of R. Warren).

²⁷⁴ W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 1 at 2, § 2 at 9 (4th ed. 1971).

²⁷⁵ See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 201 (1963); SEC v. Management Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring).

²⁷⁶ See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971).

²⁷⁷ See note 278 *infra*.

²⁷⁸ See Columbia Note, *supra* note 241, at 364 (expressing fear that broad culpability standard for injunctive enforcement would restrict public disclosure of corporate information);

In addition, in spite of the remedial function of Commission injunctions, the punitive aspects of the action often have been overlooked.²⁷⁹ In this context, it may be questioned whether the sanction is too severe for merely negligent violations of the law and whether the increased effectiveness of enforcement actions under a negligence standard may impose an unfair burden on defendants. Defendants may be subject to sanctions in both the injunctive proceeding itself and in possible subsequent judicial and administrative proceedings. In the injunctive proceeding, even if defendant is successful in escaping liability, he must nevertheless incur the expenses of litigation and weather the accompanying publicity.²⁸⁰ If an injunction does issue, the direct consequence is to place the defendant under a continuing order not to commit similar violations of the securities laws.²⁸¹ Once the district court's equitable jurisdiction attaches, however, the scope of relief may be far broader than a mere order to comply with the law. Ancillary relief that may accompany an injunction includes: disgorgement of profits;²⁸² rescission;²⁸³ appointment of a receiver, trustee, or special agent;²⁸⁴ special filing of informational reports;²⁸⁵ and a court ordered freeze on the defendant's assets.²⁸⁶ In addition to these burdens imposed as part of the injunctive proceeding itself, administrative sanctions may ensue. Certain rights and exemptions under the securities laws are automatically lost when an injunction is granted against a defendant.²⁸⁷ In addition, the Commission may in its discretion impose additional sanctions against defendants, including disqualification

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 882 (2d Cir. 1968) (Moore, J., dissenting), *cert. denied sub nom.*, Kline v. SEC, 394 U.S. 976 (1969) ("If press releases have to read like prospectuses to guard against possible 10b-5 liability, it is safe to predict that they will quickly fall out of favor with corporate management"). Cf. Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1081-82 (1969) (expressing similar concern in context of private damage actions). It has also been suggested that the issuance of a larger number of injunctions under a relaxed culpability standard would undermine the policy of the securities laws of maintaining public confidence in the securities markets, *SEC Civil Injunctive Actions*, 30 BUS. LAW. 1303, 1317 (1975), and would decrease the deterrent effect of injunctions as the "stigma" of liability decreased. See YALE NOTE, *supra* note 269, at 1044-45.

²⁷⁹ A negligence standard for the issuance of Commission injunctions has often been justified on the grounds that it is but a "mild prophylactic." See, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963).

²⁸⁰ Both the institution of a suit and its final determination are publicly reported. The defendant thus receives a "double blast" of adverse publicity. See COLUMBIA NOTE, *supra* note 241, at 342.

²⁸¹ See Matthews, *SEC Civil Injunctive Actions*, 5 REV. SEC. REG. 969, 969-70 (1972).

²⁸² See, e.g., SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972).

²⁸³ See, e.g., Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 390-91 (2d Cir.) *cert. denied*, 414 U.S. 910 (1973).

²⁸⁴ See, e.g., SEC v. Bull Inv. Group, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,010, at 97,522 (D. Mass. 1975); see also SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1105 (2d Cir. 1972).

²⁸⁵ See SEC v. Radio Hill Mines Co., 479 F.2d 4, 6-7 (2d Cir. 1973); SEC v. R.J. Allen & Assocs., 386 F. Supp. 866, 880 (S.D. Fla. 1974).

²⁸⁶ See, e.g., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1105-06 (2d Cir. 1972); SEC v. Scott, Gorman Muns., Inc., 407 F. Supp. 1383, 1388 (S.D.N.Y. 1975).

²⁸⁷ An issuer of securities subject to an injunction is deprived of a regulation A exemption under rule 252(c)(4) of regulation A, 17 C.F.R. § 230.252(c)(4) (1980). Regulation A provides a simplified form of registration which costs less to prepare and takes less time to complete than a

from professional practice before the SEC,²⁸⁸ or suspension and revocation of broker-dealer registration.²⁸⁹ Finally, violation of an injunction's prohibitions may result in prosecution for criminal contempt.²⁹⁰

Despite such potentially heavy burdens imposed on those subject to SEC injunctions, a negligence standard of culpability nevertheless would better promote the policies of the securities laws while not inflicting unreasonable harm. This is so, however, only if the two-tier standard of the common law is applied consistently. Negligent conduct should be governed only by prophylactic equitable remedies. Punitive remedies, arising in subsequent administrative or judicial proceedings, should apply only to conduct involving some element of scienter.²⁹¹ Additionally, unfairness to defendants would be minimal if the past pattern of judicial discretion were continued. Courts, consistent with the protective, rather than punitive purposes of injunctions, have granted relief to the Commission only where there exists a "reasonable likelihood" of future violations.²⁹² Thus, in order to obtain an injunction, the Commission must produce evidence sufficient to warrant the inference that future violations are likely to occur.²⁹³ "An important factor in this regard is the degree of intentional wrongdoing evident in a defendant's past conduct."²⁹⁴ With this background, it is difficult to appreciate the wisdom of substituting an inflexible scienter requirement for sound judicial discretion when the circumstances of securities law "fraud" cases vary so widely. The protection offered by the equitable discretion of the courts and the scienter requirement for punitive remedies would allow effective enforcement under a negligence standard without imposing unfair burdens on defendants.

registration statement prepared pursuant to section 5 of the 1933 Act. In addition, section 9(a)(2) of the Investment Company Act, 15 U.S.C. § 80(a)-9(a)(2) (1976), prohibits anyone subject to an injunction from serving as an employee or official of a registered investment company. The Commission, however, may waive these disqualifications pursuant to rule 252(f) under regulation A, 17 C.F.R. § 230.252(f) (1980) and Investment Company Act § 9(c), 15 U.S.C. § 80a-9(c) (1976).

²⁸⁸ See SEC Rule 2(e)(3)(i), 17 C.F.R. § 201.2(e)(3)(i) (1980).

²⁸⁹ See, § 15(b)(4)(C) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(4)(C) (1976).

A notice and hearing must precede suspension or revocation of a broker-dealer registration. *Id.*

²⁹⁰ See, e.g., *Frank v. United States*, 395 U.S. 147 (1969).

²⁹¹ Courts have concurred in the proposition that the harsher the ancillary remedy's impact on the defendant, the more restrictions should be placed on its use. See, e.g., *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1105-06 (2d Cir. 1972); *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 54 (7th Cir. 1972).

²⁹² See, e.g., *Aaron v. SEC*, 446 U.S. 680, 703 (Burger, C.J., concurring). *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 807 (2d Cir. 1975); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100-01 (2d Cir. 1972).

²⁹³ *Aaron v. SEC*, 446 U.S. at 701. Courts have denied injunctive relief where the defendant's misconduct was an isolated occurrence, or merely a momentary lapse from due care. See, e.g., *SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154, 1162 (S.D.N.Y. 1971), *modified*, 480 F.2d 341 (2d Cir. 1973), *cert. denied*, 414 U.S. 924 (1973).

²⁹⁴ *Aaron v. SEC*, 446 U.S. at 701. See COLUMBIA NOTE, *supra* note 241, at 343. Even in circuits which purported to apply a negligence standard of culpability, the SEC has usually been required to prove defendant's scienter in order to be granted injunctive relief. See, e.g., *SEC v. Bangor Punta Corp.*, 480 F.2d 341, 406 (2d Cir. 1973) (Mansfield, J., concurring), *cert. denied*, 414 U.S. 924 (1973); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100-01, 1101-02 (2d Cir. 1972).

The *Aaron* Court refused to consider the policy issues involved in determining the proper culpability standard under section 10(b) for Commission injunctions. In his concurring opinion, Chief Justice Burger indicated that the Court considered the issue closed to further judicial discussion: "[i]f, as intimated, the result is 'bad' public policy, that is the concern of Congress where changes can be made."²⁹⁵ The ALI Federal Securities Code provides that the Commission, unlike private parties seeking damages, may obtain an injunction to prevent deception and misrepresentation without proof of scienter.²⁹⁶ In light of the foregoing criticisms of *Aaron*'s reasoning and holding, it is hoped that Congress will adopt the conclusions of the ABA in its future consideration of the proposed Federal Securities Code.

CONCLUSION

Proof of scienter should not be required in Commission injunctive proceedings to enforce the prohibitions of section 10(b). In *Aaron*, the Court relied on the language and legislative history of section 10(b) in determining that proof of scienter was required under that provision regardless of the identity of the plaintiff or the nature of relief sought. This conclusion is not mandated by the language or legislative history of section 10(b), which is ambiguous as it bears on this issue. Thus, other means of discerning legislative intent are appropriate. The statutory scheme of SEC enforcement remedies reflects the common law's tradition of broader culpability standards when equitable relief is sought. This broader standard is supported by consistent and longstanding administrative construction which has enjoyed Congressional approval. Finally, a broad culpability standard for Commission injunctive actions would promote the policies of the 1933 and 1934 Acts by enabling the SEC to enforce the securities laws flexibly and efficiently without imposing unfair burdens on defendants or unduly restricting full disclosure of corporate information.

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²⁹⁵ 446 U.S. at 703 (Burger, C.J., concurring).

²⁹⁶ See ALI Federal Securities Code §§ 202(61), 202(96), 1602(a), 1819(a)(3), 1819(a)(4) (Official Draft, Mar. 15, 1978).