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The Reach of the SEC Under Rule 10b-5 Is Further Restricted: Negligent Conduct Is Insufficient to Warrant Commission Instigated Injunctive Relief

In a recent decision the United States District Court for the Southern District of New York seemingly broke with Second Circuit precedent to hold that the SEC must prove scienter to get an injunction under Rule 10b-5. The author suggests that the district court's decision is reconcilable with recent second Circuit decisions and presents reasons why the district court's holding should be adopted by the Second Circuit.

Bausch & Lomb is one of the country's leading manufacturers of optical products. In the latter part of 1971 and the early part of 1972, the company excited considerable investor interest because of its introduction into the market of a soft contact lens. Its earnings per share increased dramatically. Securities analysts paid close attention to the company during this period, especially when information adverse to the continued high performance of its stock became known. An interchange between the chairman of the board of Bausch & Lomb and an analyst had resulted in the disclosure of material inside information (earnings estimates) before it was publicly disseminated. However, shortly after divulging the earnings estimates to the analyst, the chairman had relayed to a leading financial analyst the same information in expectation that it would be published. He took further steps to insure public dissemination of the data, including the issuance two days later of a formal press release requested by the New York Stock Exchange. No insider trading occurred. The Securities Exchange Commission sought to permanently enjoin Bausch & Lomb and its chief executive officer from violations of section 78 (b) of the Securities Exchange Act of 1934,¹ and Rule 10b-5² promulgated under its aegis. The United

1. 15 U.S.C. § 78 (1970).

2. 17 C.F.R. § 240.10b-5 (1976).

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

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

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

(c) To engage in any act, practice, or course of business which operates or

States District Court for the Southern District of New York *held*: The officer's acts belie any intent to deceive. The SEC must plead and prove scienter in an injunctive action under Rule 10b-5 even where no damages are sought. *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976).³

The court, per Judge Ward, asserted that its holding was compelled by the rationale of *Ernst & Ernst v. Hochfelder*,⁴ a Supreme Court decision rendered during the course of the *Bausch & Lomb* trial. By its ruling the district court has significantly extended the reach of *Hochfelder*. In doing so, the court also has run into direct conflict with other holdings in its own circuit,⁵ as well as decisions in other circuits.

While the Second Circuit has long accepted the position taken by the Supreme Court in *Hochfelder*—that some form of scienter⁶ is a requisite element in a private action for damages under Rule 10b-5⁷—it has consistently ruled that policy considerations underlying SEC enforcement actions dictate a contrary conclusion.⁸ Injunc-

would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

3. The court also found no reasonable likelihood that the acts would be repeated. This too mitigated the basis for issuance of the injunction. 420 F. Supp. at 1244.

4. 425 U.S. 185 (1976).

5. The court cited previous injunctions it had granted based on negligence. 420 F. Supp. at 1226.

6. Although defined by the *Hochfelder* Court in the context of that case as "intent to deceive, manipulate or defraud," (425 U.S. at 193) the clear meaning of the term in other 10b-5 litigation remains elusive. See Bucklo, *Scienter and Rule 10b-5*, 67 Nw. L. Rev. 562 (1972). Even the *Hochfelder* Court left open the "question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5," (425 U.S. at 194, n.12). The meaning of scienter where enforcement proceedings are the cause of action is subject to even greater confusion. Because of the willingness of many courts to employ more lax standards where prophylactic relief is sought by the SEC, intentional acts are clothed in raiment bearing the label "negligence." See discussion beginning on p. 8 *infra*, on the Second Circuit's perspective of this issue in injunctive proceedings. See also Campbell, *Elements of Recovery Under Rule 10b-5: Scienter, Reliance, and Plaintiff's Reasonable Conduct Requirement*, 26 S.C.L. Rev. 653 (1975); Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. Rev. 482 (1970); Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. Rev. 1206 (1970). See generally Ruder, *Multiple Defendants in Securities Law Fraud Cases*, 120 U. Pa. L. Rev. 597 (1972).

7. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951). See also *Katz v. Realty Equities Corp.*, 406 F. Supp. 802 (S.D.N.Y. 1976).

8. *E.g.*, *SEC v. Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974); *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

tive suits initiated by the commission have been perceived as protective of the investing public's interest. Thus they require less restrictive parameters than a private action for personal reimbursement.

The *Bausch & Lomb* court premised its decision on the reasoning of *Hochfelder*. Yet in the latter case the Court declined to consider the precise issue which Judge Ward asserts is controlled by it.⁹ In light of other Second Circuit decisions, therefore, the critical question presented by the district court's holding is whether it is correct in its assertion that a proper reading of *Hochfelder* makes its decision compulsory.¹⁰

In the Supreme Court case, the issue was limited to "whether a *private cause of action for damages* will lie under section 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate or defraud."¹¹ In holding that it would not, the Court relied upon: (1) the language of the statute and the rule; (2) the legislative history of section 10(b); and (3) a comparison of this section with other sections of the 1933 and 1934 Act.¹²

The Court found that the word "manipulative" is a word of art when used in connection with securities markets, connoting "intentional or willful conduct designed to deceive or defraud,"¹³ and that the language "'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest(s) that § 10(b) was intended to proscribe knowing or intentional misconduct."¹⁴ The Court refuted the SEC's contention in its amicus brief that the overall remedial purpose of the Acts supersedes this language by saying:

The logic of the effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm

9. 425 U.S. at 194 n.12: "Since this case concerns an action for damages we . . . need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10-5. Cf. SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963)."

10. Another district court has recently applied the *Hochfelder* rationale to a private action for injunctive relief, but arguably a private suit is more readily encompassed under the *Hochfelder* umbrella than the instant case. *Vacca v. Intra Management Corp.*, 415 F. Supp. 248 (E.D.Pa. 1976).

11. 425 U.S. at 193 (emphasis added).

12. See also *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 280 (3d Cir.) (Adams, J., concurring and dissenting), cert. denied, 409 U.S. 874 (1972).

13. 425 U.S. at 199.

14. *Id.* at 197.

to investors But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning.¹⁵

The court concluded that Congress did not intend that anyone be made liable for illicit practices unless he had acted other than in good faith.¹⁶ “[W]hen the Commission adopted the Rule it was intended to apply only to activities that involved scienter.”¹⁷

A literal reading of *Hochfelder* then, would seem to support the district court’s conclusion. Additional support may be derived from the fact that, although *Hochfelder* had come before the Court as a private action, the bulk of the opinion was devoted to a refutation of the SEC’s amicus brief which was much concerned with the policy underlying the rule’s implementation. Moreover, although the Commission had expressed willingness to constrict the degree of negligence upon which recovery could be predicated to that which involved foreseeable reliance,¹⁸ the Court overrode this option in preference for the broader, more encompassing requirement of strictly construed scienter.

Corroboration of the district court’s contention that *Hochfelder* compelled its decision can be found in Mr. Justice Blackmun’s dissent in that case. Decrying the Court’s insistence on an allegation of intent to deceive in 10b-5 actions, he asserted that he perceived no distinction between private actions and SEC injunctive proceedings.

[S]urely the question whether negligent conduct violates the Rule should not depend upon the plaintiff’s identity. If negligence is a violation factor when the SEC sues, it must be a violation factor when a private party sues. And, in its present posture, [summary judgment dismissing the action] this case is concerned with the issue of violation, not with the secondary issue of a private party’s judicially created entitlement to damages or other specific relief.¹⁹

If Mr. Justice Blackmun is correct, *Bausch & Lomb* is correct.

The district court’s decision to abolish the distinction between SEC and private actions was made, of course, with full awareness

15. *Id.* at 198-99.

16. *Id.* at 206.

17. *Id.* at 212.

18. *Id.* at 198 n. 18.

19. *Id.* at 217-18.

of the contrary position maintained by the Second Circuit.²⁰ Its position was that the traditional policy considerations which had previously distinguished the two kinds of cases were obviated by the Supreme Court.²¹ Furthermore, the literal reading of the rule chosen by the Supreme Court should be imposed even more stringently upon the Commission than upon private litigants.²²

Despite the court's disavowal of policy concerns, beneath the literalism of its rationale may lie a policy consideration currently more potent than that disclaimed, a concern for the apprehensiveness and uncertainty of the business and professional communities engendered in recent years by the formidable implementation of Rule 10b-5.²³ A review of the relevant literature reveals a surfeit of commentary on the subject.²⁴ The case law is equally voluminous. About one-third of all securities cases in recent years were brought under Rule 10b-5.²⁵

The *Bausch & Lomb* court devotes disproportionately broad footnote coverage to circumstances which indicate the paucity of guidelines available to a corporate official to help him gauge his conduct in dealing with securities analysts. It chastises the Commission for the use of official disclaimers when staff members privately offer advice to desperate businessmen.²⁶ In short, it recog-

20. 420 F. Supp. at 1242-43 n.4.

21. Judge Ward supported his premise by citation to *Hochfelder*: "As we find the language and history of § 10(b) dispositive . . . there is no occasion to examine the additional considerations of 'policy,' set forth by the parties, . . . 425 U.S. 214, n.33, 96 S.Ct. at 1391." 420 F. Supp. at 1241.

22. "The Supreme Court found, 'the language and history of § 10(b) [are] dispositive.' . . . These stand at least as conclusively when the SEC is plaintiff If the 'language and history of § 10(b) [are] dispositive' as to the *scienter* question in private actions, must they not also be so in 'SEC suits for injunctions [which] are creatures of statute.'" (citations omitted). *Id.* at 1240-41.

23. For a comprehensive collation of pre-1972 cases as well as a superior exposition of the pertinent considerations in 10b-5 actions, see *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir.) (Adams, J., concurring and dissenting) (table of relevant cases at 312-16), *cert. denied*, 409 U.S. 874 (1972). See also Bucklo, *supra* note 6.

24. It is interesting to note the repeated references discerned in these writings to the SEC's "arsenal" of flexible enforcement powers. (See, e.g., *Hochfelder*, 425 U.S. at 195; Note, *Civil Liability Under Section 10B and Rule 10b-5*, 74 YALE L. J. 658, 659 (1965)). The images of weaponry the word evokes are particularly frightening in this era of agency disrepute.

25. Note, *Liability of Controlling Persons—Common Law and Statutory Theories of Secondary Liability*, 24 DRAKE L. REV. 621, n.4. See also Ruder, *supra* note 6, at 598, n. 1.

26. "In the absence of official pronouncements on a topic of considerable concern, however, it ill behoves the Commission . . . to assert that remarks made by its 'insiders' will not bear on how individuals attempt to conform their conduct to the law." 420 F. Supp. at 1231.

nizes the hapless dilemma of honorable people who cannot predict what effect any comment they may make will have on their reputations and careers should the heavy hand of the SEC be laid upon them for reasons they cannot foresee.²⁷

A valid argument has been proffered that use of a negligence standard in SEC injunctive actions under 10b-5(b) results in precisely the opposite effect from that desired. "[T]he sought-after goal of a free flow of corporate information might be discouraged rather than encouraged. The pragmatic rule might well become, 'when in doubt, say as little as possible.'"²⁸ It seems an eminently reasonable supposition that this consideration underlay the district court's holding as influentially as the literally applied rationale of *Hochfelder*.

The profusion of 10b-5 litigation in recent years also may have influenced the Supreme Court's decision in *Hochfelder*.²⁹ A number of contemporary Supreme Court decisions seem to indicate a generally restrictive attitude on the part of the Court where securities law litigation is involved.³⁰ Although lower courts need not be presumed to adhere to a similar point of view, *Bausch & Lomb* may be a reflection of an incipient turn-around in the attitude of the judiciary as to what segment of the investment community most needs pro-

27. See generally Loss, *Summary Remarks*, 30 BUS. LAW. 163 (Special Issue March 1975).

28. *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 287 (3d Cir. 1972).

29. A memorandum to staff attorneys by the SEC's general counsel noted that recent cases evidence a trend in the Supreme Court to limit access by private parties to the federal courts. Of course, the SEC feels this restrictive attitude does not apply to Commission instituted suits. *SEC General Counsel's Memorandum Regarding Ernst & Ernst v. Hochfelder*, [1976] SEC. REG. & L. REP. (BNA) (May 26, 1976, F-1, F-2).

30. See Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976). The author remarks:

Heretofore, in rule 10b-5 matters, I used to take as my premise . . . Painter's witty insight that rule 10b-5 was like the medieval alchemist's 'universal solvent' which was so potent that it dissolved every container employed to hold it Now, the Supreme Court's . . . attitude seems to hint that the Court may have an alchemy of its own for the containment of rule 10b-5 which it will from time to time disclose.

Id. at 895-96

Kaplan points to the court's holding in *Blue Chip Stamps Co. v. Manor Drug Co.*, 421 U.S.723 (1975), as the seminal case in revealing the Court's braking process, saying the opinion resembles "a proclamation . . . to the inferior federal courts, urging more restrictive interpretations of rule 10b-5 and possibly of the Securities Act in general." 31 BUS. LAW. at 896. Had *Hochfelder* been handed down when his article was written, he might have pointed to it as the apex of an already formidable configuration. Compare with *SEC General Counsel's Memorandum*, *supra* note 29 at F-2.

tection in light of the uncertain atmosphere of the corporate environment vis-a-vis prospective litigation.

Other cases in which the Second Circuit has dealt with the question of the correct standard of culpability to be applied in SEC injunctive actions need not be dispositive of the endurance of *Bausch & Lomb's* holding. But of course, they bear pertinently on how receptive the circuit court will be to accepting Judge Ward's insistence that his decision was a compulsory one. Often, the broad language employed by this circuit has belied the factual underpinnings of the cases in which the language was uttered.

The reasoning of the *Bausch & Lomb* court may be acceptable to the Second Circuit for the precise reason asserted by Judge Ward—because it is compelled by *Hochfelder*. Yet since the Supreme Court officially left the question open, it is more reasonable to assume that the Second Circuit will adhere to previously declared principles if they cannot be reconciled with *Bausch & Lomb's* interpretation of *Hochfelder*. It is the contention of this writer that such a reconciliation can be affected, although not without compromise, and that the language of the cases provides the basis upon which to build this accord. Even if outright intent to deceive is not the ultimate test decided upon, willful disregard may provide the preferred standard for injunctive actions. This at least is more acceptable than the negligence standards so loosely articulated in the past.

Despite repeated assertions that SEC injunctive actions stand on a different footing from private suits with respect to the requisite standard of behavior, all of the Second Circuit cases have required, at a minimum, an allegation of actual knowledge or willful omission. Injunctions have not been ordered in situations where a defendant's lack of actual knowledge was shown or where his failure to inquire was deemed excusable.³¹

The penultimate 10b-5 case in the Second Circuit is surely *SEC v. Texas Gulf Sulfur Co.*³² Briefly, the case involved the issuance of a misleading press release regarding the importance of a newly discovered mineral deposit, and insider trading on the basis of knowledge not accessible to the general public. The main opinion ex-

31. See generally *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir.) cert. denied, 409 U.S. 874 (1972); *Bucklo*, supra, note 6, at 596; *Mann*, supra, note 6, at 1208; Comment, *Scienter & Rule 10b-5*, 69 COLUM. L. REV. 1057, 1066 (1969), and cases discussed *infra*.

32. 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

pressed a version of the scienter requirement with which only four judges agreed. In language unduly ambiguous, Judge Waterman stated:

[W]hether the case before us is treated solely as an SEC enforcement proceeding or as a private action, proof of a specific intent to defraud is unnecessary. In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful.³³

He went on to flesh out his opinion, saying: "Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent . . . the securities laws should be interpreted as an expansion of the common law both to effectuate the broad remedial design of Congress . . . and to ensure uniformity of enforcement

"³⁴

It is precisely this void (absence of a showing of legislative intent) which *Hochfelder* has filled by its definitive interpretation of legislative intent. The approach of the *Bausch & Lomb* court is strengthened by retrospective examination of Judge Waterman's opinion. It fairly may be said that *Texas Gulf Sulfur's* loosely construed negligence standard no longer remains viable even in SEC enforcement actions.

In his widely quoted concurring opinion in *Texas Gulf Sulphur*, Judge Friendly stated his reservations regarding the negligence standard applied in the majority opinion. He pointed out that such a standard is likely to frustrate, not further, the larger goals of the securities laws, and asserted that even where injunctive sanctions are at issue, it can be argued that "Rule 10b-5(2), absent the reading in of a *scienter* requirement, goes beyond the authority granted by § 10(b) of the 1934 Act."³⁵

Hard on the heels of its *Texas Gulf Sulfur* decision, the Second Circuit decided *SEC v. Great American Industries, Inc.*³⁶ The SEC sought a preliminary injunction because of omissions in press releases and 8-K reports³⁷ and because of failure to disclose unusually

33. *Id.* at 854-55 (footnote omitted).

34. *Id.* at 855 (footnote omitted).

35. *Id.* at 868.

36. 407 F.2d 453 (2d Cir. 1968), *cert. denied*, 395 U.S.920 (1969).

37. "8-K reports" are annual reports required to be filed by certain issuers of registered

high finder's fees in the acquisition of mining properties. Despite his statement that inadvertence and prompt correction do not defeat the SEC's right to injunctive relief,³⁸ Judge Friendly, speaking for the majority, observed: "The evidence . . . compelled a finding that the deficiencies in the press releases and reports were not merely negligent . . . but something more."³⁹ As to the failure to disclose that large finder's fees were to be paid in connection with the purchase of property by Great American, the court allowed the injunction only where actual knowledge by the corporate purchaser was shown. The decision did not rest on some nebulous concept of undefined duty, but on a continuing course of deception or omission.

In *SEC v. Frank*,⁴⁰ the SEC sought to restrain an attorney from drafting allegedly misleading documents describing a chemical product. *Scienter* was not directly at issue, and the injunction was dissolved on other grounds, but Judge Friendly indicated that an attorney would not be liable for negligence in a field where his expertise was not directly relevant to the function he performed (the attorney was translating technical language into more understandable terms). The judge implied, however, that recklessness would be equivalent to willful deception from which intent could be inferred.

*Hanly v. SEC*⁴¹ was an SEC enforcement action which resulted in the barring of securities brokers from practicing because of willful and deliberate misrepresentations. Though the court adverted to the loose standard of negligence set forth in *Texas Gulf Sulfur*, it actually predicated its approval of the injunction on the deliberately deceptive conduct of the individuals censured.

In *SEC v. Manor Nursing Centers, Inc.*⁴² the Commission sued for both injunctive and ancillary relief (disgorgement) against defendants who had promised to return investors' money if their total offering of stock was not purchased. Although the offering was not completely sold out, defendants kept the funds. While most of the defendants had acted with *scienter* sufficient to meet the stringent definition later to be set forth in *Hochfelder*, three were less culpa-

securities, 17 C.F.R. §§ 240.13a-11, .15d-11 (1976). The 8-K report is required to be filed upon the happening of certain events, including the acquisition of substantial assets not in the ordinary course of the issuer's business. Form 8-K, 17 C.F.R. § 249.308 (1976).

38. 407 F.2d at 457.

39. *Id.* at 458.

40. 388 F.2d 486 (2d Cir. 1968).

41. 415 F.2d 589 (2d Cir. 1969).

42. 458 F.2d 1082 (2d Cir. 1972).

ble than the others. Their error had been failure to exercise diligent inquiry when stop payments had been issued on their original checks and the second checks came from the corporation rather than a buyer, events which the court said should have alerted them that something was amiss.

This case involved a violation of Rule 10b-9⁴³ rather than 10b-5, a significant difference. The language of 10b-9 deals specifically with “all or nothing” offerings and even these defendants were found to have “*deliberately* closed their eyes to facts which they, as selling shareholders who were to receive a substantial financial benefit, were under a duty to see”⁴⁴ Even though a negligence standard was applied, there had existed an element of profiteering in a continuing course of conduct at the expense of the investing public. Thus “negligence” in this circumstance might well be regarded as a label for more culpable behavior.

In 1973, the Second Circuit handed down its opinion in *SEC v. Spectrum, Ltd.*⁴⁵ The Commission sought a preliminary injunction against an attorney who had prepared an opinion letter used to facilitate the sale of unregistered securities. In remanding the case for an evidentiary hearing, Judge Kaufman rejected the “actual knowledge” standard utilized by the district court, alluding to it as “a sharp and unjustified departure from the negligence standard which we have repeatedly held to be sufficient in the context of enforcement proceedings”⁴⁶ Despite this broad language, Judge Kaufman made it clear that he utilized these words in the context of a proceeding against a knowledgeable professional to whom a particularly stringent measure of diligence applied. The standard of culpability appropriate in such a situation was not to be applied to more peripheral participants in an illicit scheme. The court emphasized in a later case⁴⁷ its intention that it be clearly understood that the crucial element in *Spectrum* had been that the defendant’s responsibility “be measured by the appropriate standard of negligence, that is, the defendant should have been able to conclude that his act was likely to be used in furtherance of illegal activity.”⁴⁸

43. 17 C.F.R. § 240.10b-9 (1976).

44. 458 F.2d at 1097 (emphasis added).

45. 489 F.2d 535 (2d Cir. 1973).

46. *Id.* at 541.

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

48. *Id.* at 811.

Once again it seems clear that "something more" than ordinary negligence was the true principle by which defendant's acts were measured. The expressed generality belied the facts.

The circuit court, in *SEC v. Shapiro*,⁴⁹ approved injunctive sanctions against another knowledgeable professional (a specialist in corporate mergers) for repeated trading on the basis of material inside information which he knew was not available to the public. Although the court stated that it was not necessary to show bad faith where the SEC seeks injunctive relief, it noted that the lower court had found the individual to have exhibited "driving cupidity and lack of principle and restraint."⁵⁰

*SEC v. Management Dynamics, Inc.*⁵¹ is notable for its thoughtful discussion of the circumstances under which the granting of a Commission-sought injunction is appropriate. The case involved two facets of alleged misbehavior: deliberate manipulative actions in the corporation's unregistered stock by a director who was also an experienced securities lawyer, and shady maneuvers engaged in by brokers in order to give an appearance of activity in the stock and thereby raise its price. While theoretically adhering to the negligence standard expressed in *Texas Gulf Sulfur*, the court refused to enjoin non-volitional violations of the securities laws, and indeed warned the judiciary not to "set aside all notions of fairness because it is the SEC, rather than a private litigant, which has stepped into court."⁵²

Fundamental to the approach taken by the *Management Dynamics* court was the concept that the Commission appeared as the protector of the public interest, and "the standards of the public interest, not the requirements of private litigation measure the propriety and need for injunctive relief."⁵³ This concept was referred to once again in *SEC v. Geon Industries, Inc.*⁵⁴ (involving, *inter alia*, a brokerage house's liability for the acts of its employees), but the court determined that the damage that would be done by enjoining a brokerage house outweighed even these higher standards.

Two relevant cases have been decided by the Second Circuit

49. 494 F.2d 1301 (2d Cir. 1974).

50. *Id.* at 1308.

51. 515 F.2d 801 (2d Cir. 1975).

52. *Id.* at 808.

53. *Id.*, quoting *Hecht Co. v. Bowles*, 321 U.S. 321, 331 (1944).

54. 531 F.2d 39 (2d Cir. 1976).

since the district court rendered its decision in *Bausch & Lomb*. In the first, *Arthur Lipper Corp. v. SEC*,⁵⁵ the court was called upon to review a harsh penalty imposed upon an over the counter broker in an SEC administrative proceeding. The defendant was found to have willfully aided and abetted a violation of Rule 10b-5 by improperly rebating a portion of his commissions on transactions emanating from the IOS debacle of recent years.⁵⁶ In reducing the penalty imposed by the Commission, the court adverted to the issue of scienter. The question of an appropriate standard of culpability arose in the context of Section 15 of the Securities Exchange Act of 1934.⁵⁷ This section authorizes the SEC to invoke specified penalties against a broker or dealer for a number of infractions including willful violation of any rule imposed under the Act. Thus violation of Rule 10b-5 is punishable by the Commission under section 15. For years, courts have held that willfulness under section 15 meant merely intentional commission of the act which constitutes the violation. There was no requirement of evil motive or of intent to violate the law.⁵⁸

Defendant argued that *Hochfelder's* scienter requirement was applicable in this situation. The court agreed with this argument and assumed without deciding that the *Hochfelder* standard applies in disciplinary proceedings. Judge Friendly, speaking for the court, used the opportunity the case afforded to clarify the approach the court will take in delimiting scienter.

He stated that since the *Hochfelder* plaintiffs "had claimed nothing more than negligence, the [Supreme] Court had no occasion to refine its definition of *scienter* . . . and [left] open the question whether reckless behavior would suffice to meet [the test]"⁵⁹ He then found that *Hochfelder* was no help to this defendant. Any transgression against the exhortation, "Thou shalt not devise any other cunning devices," is sufficient to satisfy the scien-

55. 547 F.2d 171 (2d Cir. 1976).

56. This "debacle" came about through the collapse of IOS Ltd., a Canadian financial service firm engaged principally with the investment of off-shore funds in the United States. Litigation resulting from the collapse includes at least three United States Courts of Appeals cases.

57. 15 U.S.C. § 780 (1970) (amended in part 15 U.S.C. § 780 (Supp. V 1975)).

58. *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 468 (2d Cir.), cert. denied, 361 U.S. 896 (1959); *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949). See also 2 LOSS, SECURITIES REGULATION 1309 (1961).

59. 547 F.2d at 180-81.

ter requirement under this interpretation of scienter, whether or not defendant knows that the "cunning device" employed is a fraud.⁶⁰

This case was not an injunctive proceeding, and thus cannot be directly helpful in predicting what conclusions the Second Circuit will reach in deciding *Bausch & Lomb* on appeal. Indeed, the court alluded to the difference between injunctive proceedings, "the objective of which is solely to prevent threatened future harm," and disciplinary actions, which it felt were more closely akin in the seriousness of their consequences, to private damage actions.⁶¹ But it does indicate that scienter can be construed to include reckless behavior,⁶² and it does show a willingness on the part of the Second Circuit to extend *Hochfelder* beyond the parameters of private damage actions. It is submitted that a definition of scienter which embraces reckless behavior is a possible first step in applying the *Hochfelder* rationale to SEC initiated injunctive suits.

On December 16, 1976, about a week after *Lipper* was decided, the Second Circuit handed down its opinion in *SEC v. Universal Major Industries, Corp.*⁶³ Although the action was not brought under Rule 10b-5, it is pertinent to the issue of the scienter requirement in injunctive actions. An attorney was convicted of aiding and abetting the corporation in selling unregistered securities in violation of section 5 of the Securities Act of 1933.⁶⁴ He had written opinion letters in carefully qualified language which the court found to have given purchasers misleading assurances that the sale was legal.

The pronouncements in the decision, like those in several previously discussed cases, contain broad assertions, readily embraced by facile interpreters to substantiate propositions not warranted by a careful review of modifying language in the same opinion. The court noted that it did "not believe the Supreme Court [in *Hochfelder*] intended that those who play an indispensable role in the sale . . . should not be subject to SEC initiated, injunctive restraint."⁶⁵ It added: "[I]n SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone,

60. *Id.* at 181.

61. *Id.* at 180.

62. *Cf.* *SEC v. Coffey*, 493 F.2d 1304 (2d Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).

63. 546 F.2d 1044 (2d Cir. 1976).

64. 15 U.S.C. § 77e (1970). Section 5 makes it unlawful, directly or indirectly, to sell unregistered stock.

65. 546 F.2d at 1046.

and scienter is not required. While this rule has not met with universal approval . . . it is nonetheless the law of this Circuit."⁶⁶

Although this was not a 10b-5 case, this language, if read alone, would lead one to assume that *Bausch & Lomb* must fall. Yet these words were modified by a footnote in which the court said: "In any event, the District Court's finding that appellant acted with 'knowledge or reckless disregard of truth' removes the props from under appellant's basic argument."⁶⁷ Moreover, returning to the text of the opinion, the court stated:

[O]ur decision need not rest on our rejection of appellant's negligence-scienter argument, because the District Court found that appellant in some circumstances knew and in other circumstances had reason to know that his client was engaging in illegal transactions with the aid of appellant's letters and that appellant's acts were performed with knowledge or reckless disregard of the truth. This . . . is sufficient to establish scienter.⁶⁸

Once again the bald assertion that negligence suffices in SEC initiated injunctive actions was accompanied only peripherally by clarifying observations. A more definitive statement of the outside limits of what constitutes sufficient "negligence" in such cases must be advanced so that time-wasting, expensive litigation can be avoided. It is suggested that what has been at issue in those cases in which culpability has been found is not really negligence at all, but such willful conduct as may properly be classified beneath the umbrella of scienter as defined by Judge Friendly in *Lipper*. A clear pronouncement of this fact is sorely needed.

Because of the Second Circuit's assertion in *Universal Major* that an SEC injunctive action may be predicated upon negligence alone, the Commission, in January 1977, moved for an unusual "summary reversal" of the *Bausch & Lomb* decision. In February, the circuit court denied the Commission's motion.⁶⁹ The opportunity remains open to the Second Circuit to clarify, in precise terms, just what kind of behavior is sufficiently culpable to justify injunctive sanction.

66. *Id.* at 1047 (footnote omitted).

67. *Id.* n.1.

68. *Id.*

69. See Kohn, *SEC Loses Bid for Remand of Bausch & Lomb Ruling*, *New York Law Journal*, Feb. 9, 1977 at 1, col. 3. The court offered the commission an expedited appeal, but the SEC refused.

It is apparent that the Second Circuit has steadfastly adhered to a position which seems at odds with *Bausch & Lomb's* contention that literalism must overwhelm policy if the rationale of *Hochfelder* is to be followed. A satisfactory compromise need not be an illusion in spite of the visible dichotomy. Although it is unlikely that the Second Circuit will desert its policy position altogether, nothing in its prior holdings need preclude the application of a new approach which defines scienter so as to encompass willful disregard of the public interest and requires that scienter, as thus construed, be pleaded and proven in an injunctive action brought by the SEC. Since the defendants in *Bausch & Lomb* clearly did not intend to engage in deceptive or manipulative activities, it would be perfectly consistent with both the policy and the actuality of prior Second Circuit holdings for this case to serve as the vehicle for a re-definition of the standard of culpability required in SEC injunctive suits. The exhortation in *Management Dynamics* that fairness must not be forgotten merely because the SEC is the plaintiff can be implemented by such a re-definition.

Since 1974 the Sixth Circuit has held that in injunctive proceedings under 10b-5(2), the SEC must show at least "willful or reckless disregard for truth."⁷⁰ Yet the opposite perspective remains viable. Subsequent to the *Bausch & Lomb* decision, a district court in California ruled that for the limited purposes of that case, proof of scienter was not necessary in an SEC enforcement action.⁷¹ The Second Circuit itself has reasserted this position, and the First Circuit has recently ruled that *Hochfelder* only applies to private damage suits for past actions.⁷²

In *SEC v. World Radio Mission, Inc.*⁷³ the First Circuit faced a situation in which a religious organization not only had failed to reveal its shaky financial status while offering securities, but had

70. *SEC v. Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). (Even if investment of state funds in corporate notes was illegal, no violations of the securities laws would be found if defendants acted without intent to deceive, as measured by a standard of reckless disregard for truth.)

71. *SEC v. Geotek*, [1976] FED. SEC. L. REV. (CCH) ¶ 95,756 (N.D. Cal. Nov. 11, 1976). It is noteworthy that the court stressed that it had adopted the negligence standard for the purpose of that case only, since defendants were not even found negligent. It is arguable that if a clearer standard, e.g., the *Hochfelder* scienter requirement, were adopted for SEC injunctive actions, a more efficient use of tax dollars might be encouraged, for such suits as this one would not be brought.

72. *SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976).

73. *Id.*

evidenced its intentions of continuing practices which the court found deceptive. The SEC did not press the scienter issue. For understandable reasons it chose to regard it as immaterial.⁷⁴ Yet Judge Aldrich, speaking for the court, ruled:

From the standpoint of an SEC injunction against violations which the court finds are likely to persist, a defendant's state of mind is irrelevant. If proposed conduct is objectively within the Congressional definition of injurious to the public, good faith, however, much it may be a defense to a private suit for past actions, . . . should make no difference.⁷⁵

The court did add that prior adjudication had already evidenced defendant's intent to commit acts which a federal court had found deceptive, but this deference to logical thinking does not eliminate the court's unwillingness to *demand* a finding of intent to deceive prior to issuance of an injunction. The Second Circuit has observed that the degree of scienter may "be highly relevant to a determination of whether the defendant has a propensity to commit future violations, a requisite to injunctive relief."⁷⁶ If Judge Aldrich in *World Radio Mission* had asserted only that, *after* the fact has been found that violations are likely to persist, state of mind becomes inconsequential, no objection would lie. But instead, he chose to proclaim *Hochfelder* irrelevant to SEC injunctive suits. The initial determination of likely recurrence, a sine qua non of injunctive proceedings, cannot be made in the absence of consideration given to the state of mind of the defendant. While scienter may not be the preeminent consideration in injunctive proceedings, this position is reserved for consideration of the likelihood of recurrence. It is a vital prerequisite to the determination of whether an injunction should issue at all.

It makes little sense to enjoin behavior which is merely negligent under the banner of a statute which is directed against fraudulent behavior. Where negligence alone exists, the SEC has administrative procedures at its disposal which better serve both the negligent individual and the investment community.

The consequences of an injunction are not lightly borne. It must

74. See *SEC General Counsel's Memorandum*, *supra* note 29, at F-3.

75. 544 F.2d at 540.

76. *SEC v. Spectrum Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973). The Court, however, rejected the scienter standard and accepted the negligence standard.

be reported on government forms, and it can lead to disbarment or compulsory resignation from federally-funded employment.⁷⁷ It places individuals in permanent jeopardy of criminal sanctions for future violations.⁷⁸ Although SEC injunctive actions will have no res judicata effect if subsequent private actions should ensue⁷⁹ the mere existence of an injunction may motivate vexatious would-be litigants to harass enjoined corporations with threats of private suits for their settlement value alone.⁸⁰

To predicate such perils on non-willful behavior is a restriction of freedom of action which smacks of totalitarianism. Moreover, if a corporation has been subjected to injunctive imprimatur, its stockholders—the very people who were intended to be among the beneficiaries of the law's protections—may ultimately pay the price of corporate disrepute in lowered stock values. To impose such consequences on the basis of a section of the law under which no definitive standards of acceptable conduct exist (What may one safely divulge to a securities analyst? What are the parameters of an acceptable press release about a newly discovered mineral deposit? When does a prospective merger become sufficiently definite to require divulgence?) is to ask too much of any citizen. In balancing the hardships imposed against the benefits accrued, the negligence standard emerges wanting.

Having considered the logic of *Bausch & Lomb* in the light of *Hochfelder*, the background of the case law in the Second Circuit and the conflicts among the courts, it remains to reflect upon the likely attitude of the Commission itself. Armed with the recent decisions in *SEC v. Universal Major Industries Corp.*⁸¹ and *SEC v. World Radio Mission*⁸² plus the Supreme Court's non-inclusion of injunctive actions within the necessary constraints of *Hochfelder*, the Commission may be expected to assert that a private damage action is "significantly distinguishable from Commission actions."⁸³ In so doing it wields the sword of prior Second Circuit holdings which support this position. It may argue that where damages are

77. 25 EMORY L.J. 465, 473 (1976).

78. *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 888 (2d Cir. 1968) (Moore, J. dissenting), cert. denied, 394 U.S. 976 (1969).

79. *SEC v. Standard Life Corp.*, 413 F. Supp. 84 (W.D. Okla. 1976).

80. See *Blue Chip Stamp Co. v. Manor Drug Co.*, 421 U.S. 723 (1975).

81. 546 F.2d 1044 (2d Cir. 1976).

82. 544 F.2d 535 (1st Cir. 1976).

83. *SEC General Counsel's Memorandum*, supra note 29, at F-2.

involved, private parties often come before the courts with suits which are merely vexatious. To this situation it would contrast its protective stance and assert that its prophylactic actions are directed toward the prevention of future violations while suits for damages are based on past violations.⁸⁴ It may, in appropriate situations, argue that "it is not necessary in order to obtain an injunction that we establish a past violation of the law."⁸⁵ In refutation of this argument, it has already been noted that scienter is inextricably involved with the likelihood of future violations. When due regard is given to the possible consequences of the imposition of injunctive sanctions on a merely negligent defendant, such assertions should be overcome.

The Commission also is likely to rely on *SEC v. Capital Gains Research Bureau, Inc.*⁸⁶ cited in *Hochfelder*,⁸⁷ for the proposition that "it is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."⁸⁸ This case was decided over a decade ago by a different Court. Moreover, as pointed out by Judge Adams' concurring opinion in *Kohn v. American Metal Climax, Inc.*:

There is nothing in *SEC v. Capital Gains Research Bureau Inc.* (citation omitted) indicating that proof of fraud is an obsolete requirement. The Government there sought an injunction under the Investment Advisors Act of 1940, which contains language similar to that found in Section 10(b), to compel a registered investment advisor to disclose to its customers its practice of purchasing securities, recommending purchases of those securities by the subscribers to the service, and then selling the securities at a profit The Supreme Court based its holding on the fiduciary relationship existing between an advisor and his client *Capital Gains Research Bureau* can be read as expanding the scope of Section 10(b) by including in the requirement of fraud the concept of constructive fraud, *but it in no way eliminates the requirement altogether.*⁸⁹

Thus this argument too, is refutable.

84. *Id.*

85. *Id.*

86. 375 U.S. 180 (1963).

87. See discussion in note 9, *supra*.

88. 375 U.S. at 193.

89. 458 F.2d 255, 282 (Adams, J. concurring and dissenting) (emphasis added).

If all else fails, the Commission may be expected to advert to the fact that *Hochfelder* merely required that *some* element of scienter be shown, and fall back on the standard of recklessness as sufficient.⁹⁰ It is this position which is likely to be acceptable to the Second Circuit, for it affords reasonable middle ground upon which to compromise.

As a final matter, the General Counsel's office recommends to SEC staffers that "whenever possible" they include allegations of violations of statutory provisions and rules additional to section 10(b) and 10b-5.⁹¹ Other commentators have noted the likelihood that such eventuations would be forthcoming,⁹² and it seems reasonable to expect that this will be so. As 10b-5 actions diminish in number, suits brought under other sections of the securities laws are likely to proliferate.

Bausch & Lomb is correct in asserting that a proper reading of *Hochfelder* compels some form of scienter to be pleaded and proven by the SEC as well as by private plaintiffs in any action brought under the aegis of section 10(b) and Rule 10b-5. This position is supported by: (1) The rationale of *Hochfelder*; (2) Mr. Justice Blackmun's correct observations that the plaintiff's identity should not determine the violation factor; (3) a perceivable Supreme Court policy of restrictive enforcement of 10b-5 actions; (4) the likelihood that a negligence standard effectively constricts rather than enlarges the free flow of information; (5) the preventive rather than punitive nature of injunctive relief; and (6) the possibly profound consequences of the imposition of an injunction on the individuals and corporations involved. Because it philosophically supports the prophylactic functions of Commission injunctive suits, the Second Circuit is unlikely to accept *Bausch & Lomb's* ruling without collateral reformation of the concept of scienter. Therefore, the true impact of the decision is likely to be its influence on the interpretation the circuit court gives to the words "intent to deceive, manipulate or defraud" in the context of Commission injunctive actions.

At the least, it is to be hoped that the theoretical invocation of a broad negligence standard will be eliminated, and in its stead the court will adopt a clearly defined, modified concept of scienter for

90. SEC General Counsel's Memorandum, *supra* note 29, at F-2.

91. *Id.* at F-3.

92. See, e.g., Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How it Compares with Rule 10b-5*, 13 Hous. L. Rev. 231 (1976).

SEC injunctive suits. A definition of intent which draws the bottom line at willful disregard of truth, or reckless disdain for the public interest is not inappropriate, for intent to deceive can fairly be interpolated from such acts. The Second Circuit has already promulgated such a definition in *Universal Major*. The standard should always be applied with reference to a particular defendant's degree of responsibility. An injunction should not issue in the absence of actual knowledge that the statement or omission was false or deceptive,⁹³ unless evidence is adduced that there is likelihood of a future willful violation. Despite prior pronouncements to the contrary by the Second Circuit, good faith should be a defense to an attempted SEC injunction, lest the injunctive process appear punitive rather than preventive.

Such parameters accommodate the two relevant policy concerns: protection of the individual investor and recognition of the realities of the business world. They adhere to the spirit of *Hochfelder* if not to its letter. They in no way impair the efficacy of the Commission as the public's watchdog in financial matters. Restrained intervention is both more efficient and more effective than excessive zeal to protect the entire investment community.

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93. See Comment, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057, 1080-81 (1969). Compare *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973), in which an "actual knowledge" standard was rejected, with *SEC v. Great Am. Ind., Inc.*, 407 F.2d 453 (2d Cir. 1968), where an injunction was approved only when actual knowledge of omitted facts was shown.