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# Scienter as an Element in SEC Enforcement Actions

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## I. Introduction

In recent years section 10(b) of the Securities Exchange Act of 1934[1] and rule 10b-5[2] promulgated thereunder have become one of the most frequently litigated areas of securities law. Both the statutory section and the rule deal with fraudulent and misleading practices in connection with the purchase or sale of securities.[3] Litigation under section 10(b) and rule 10b-5 has generally arisen from enforcement actions instituted by the Securities and Exchange Commission[4] and from private actions for damages.[5]

While both private plaintiffs and the SEC must base their actions upon the same statutory language, each approaches such litigation from a

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1. 15 U.S.C. § 78j(b) (1970) [hereinafter referred to as 1934 Act].
2. 17 C.F.R. § 240.10b-5 (1976).
3. The pertinent language of the statute provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1970). Rule 10b-5, promulgated by the SEC in 1942, provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, 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.

17 C.F.R. § 240.10b-5 (1976).

4. The Securities and Exchange Commission [hereinafter SEC] was established under Section 4 of the Securities Exchange Act of 1934, 15 U.S.C. § 78d (1970). Prior to passage of this Act, authority to regulate securities was vested in the Federal Trade Commission. *See* Securities Act of 1933, ch. 38, § 2(5), 48 Stat. 75 (1933) (codified at 15 U.S.C. § 77b(5) (1970)). For purposes of this comment, suits brought by the SEC to enjoin violations of the securities laws will be termed enforcement actions.

5. Neither section 10(b) nor rule 10b-5 specifically authorizes a private cause of action, but courts have recognized that private plaintiffs have an implied right to recover monetary damages. *See* notes 96-99 and accompanying text *infra*.

For purposes of this comment, civil suits to recover monetary damages will be termed private damages actions.

different perspective. In seeking monetary damages on his own behalf, the private plaintiff looks to the federal courts to provide restitution for past 10b-5 violations. The SEC, on the other hand, seeks to protect the investing public from fraudulent or deceptive practices by enjoining continued or threatened 10b-5 violations. Consequently, courts have purported to distinguish private damages actions from enforcement actions with respect to the plaintiff's burden of proof.[6] They have not always been successful.[7]

One of the most unsettled areas in rule 10b-5 litigation is the necessity of establishing scienter on the part of the defendant. In *Ernst & Ernst v. Hochfelder,*[8] a private damages action brought under rule 10b-5, the Supreme Court has seemingly put to rest considerable confusion among the circuit courts[9] by requiring a private plaintiff to plead and prove scienter as an element of his burden of proof under rule 10b-5. While the Court specifically left unresolved the applicability of a scienter requirement to enforcement actions,[10] more than one court has extended the Supreme Court's analysis in *Hochfelder* to require that the SEC establish scienter as part of its burden of proof in enforcement actions.[11] Other courts, emphasizing the inherent differences between private dam-

6. The characteristics, purposes, and requirements of private damages actions brought under a federal regulatory statute have often been judicially contrasted with remedial actions brought by the statutory enforcement agency. *See* Hecht Co. v. Bowles, 321 U.S. 321 (1944); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); FTC v. Rhodes, 191 F.2d 744 (7th Cir. 1951); SEC v. Petrofunds, Inc., 420 F. Supp. 958 (S.D.N.Y. 1976).

7. *See, e.g.,* SEC v. Coffey, 493 F.2d 1304 (6th Cir.), *cert. denied,* 420 U.S. 908 (1974). In denying the SEC's injunction, the court relied on the Second Circuit's decision in Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973), a private damages action under rule 10b-5, to require the SEC to make a similar showing of scienter in an enforcement action. The case has been criticized for unnecessarily confusing the traditional distinctions between private suits and enforcement actions. *See* 18 HOWARD L.J. 854 (1975).

8. 425 U.S. 185 (1976).

9. Prior to the *Hochfelder* decision a sharp conflict existed among the circuit courts regarding the standard of liability in private suits under rule 10b-5. The Seventh, Eighth, and Ninth Circuits did not require a scienter standard, holding some form of traditional negligence sufficient to establish civil liability. *See, e.g.,* White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Swanson v. American Consumer Indus. Inc., 475 F.2d 516 (7th Cir. 1973); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). The remaining circuits have adopted some form of a scienter standard. *See, e.g.,* Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) (scienter or conscious fault necessary); SEC v. Coffey, 493 F.2d 1304 (6th Cir.), *cert. denied*, 420 U.S. 908 (1974) (dictum); Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974)(mere negligence insufficient for civil liability); Cohen v. Franchard Corp., 478 F.2d 115 (2d Cir.), *cert. denied* 414 U.S. 857 (1973) (no liability for "mere negligence"); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972) (plaintiff must show fraudulent misrepresentation); Johns Hopkins Univ. v. Hutton, 343 F. Supp. 245 (D. Md. 1972), *rev'd in part on other grounds,* 488 F.2d 912 (4th Cir. 1973), *cert. denied,* 416 U.S. 916 (1974).

10. "Since this case concerns an action for damages we also need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976).

11. SEC v. American Realty Trust, 429 F. Supp. 1148 (E.D. Va. 1977); SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976). *See* notes 91-105 and accompanying text *infra*.

ages actions and enforcement actions, have expressly rejected such an extension.[12]

This comment will examine the propriety of a scienter standard in enforcement actions. First, the statutory remedies available to the SEC as part of its enforcement powers will be examined.[13] Second, the effect of the *Hochfelder* decision on the statutory and judicial requirements for an enforcement action will be explored by analyzing the case law development of the meaning and applicability of a scienter standard before and after *Hochfelder.*[14] Last, public policy considerations will be scrutinized to determine the proper role of scienter in enforcement actions.[15]

## II. The Nature of SEC's Enforcement Role

### *A. The Remedies Available*

The SEC is vested with the administrative responsibility of enforcing the various securities laws.[16] Upon receipt of investor complaints,[17] the SEC is specifically empowered[18] to conduct a formal investigation.[19] If the results of the investigation disclose that a securities law violation has taken place, the SEC may choose from an imposing array of remedial measures. The enforcement options available to the SEC can be grouped into four procedural categories: (1) summary actions under specific statutory authority; (2) criminal referrals to the Justice Department; (3) administrative enforcement proceedings; and (4) enforcement actions brought in a United States district court. In carrying out its enforcement

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12. SEC v. Universal Major Indus. Corp., 546 F.2d 1044 (2d Cir. 1976); SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976); SEC v. Geotek Resources Fund, Inc., 426 F. Supp. 715 (N.D. Cal. 1976); SEC v. Galaxy Foods, Inc., 417 F. Supp. 122 (E.D.N.Y. 1976). *See* notes 106-11 and accompanying text *infra*.

13. *See* notes 16-60 and accompanying text *infra*.

14. *See* notes 61-126 and accompanying text *infra*.

15. *See* notes 127-150 and accompanying text *infra*.

16. The SEC is generally responsible for the enforcement of the following statutes [hereinafter collectively referred to as securities laws] dealing with the regulation of securities or securities-related industries and individuals: Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-77hh (1970); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-b (1970); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1970); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1970).

17. The SEC receives a large volume of investor complaints each year. Most complaints deal with operational problems, such as mishandling of accounts or failure to deliver securities or funds promptly by broker-dealers, and are usually resolved through SEC staff inquiries. In 1976 approximately 16,300 complaints were received, of which 5,300 were complaints against broker-dealers and 11,000 related to issuers, investment advisers, mutual funds, or related matters. 42 SEC ANN. REP. 107 (1976).

18. The SEC is granted specific authority to conduct formal investigations under each of the six securities laws. Securities Act of 1933, § 19(b), 15 U.S.C. § 77s(b) (1970); Trust Indenture Act of 1939, § 321(a), 15 U.S.C. § 77uuu(a) (1970); Securities Exchange Act of 1934, § 21(a), 15 U.S.C. § 78u(a) (1970); Public Utility Holding Company Act of 1935, § 18(a), 15 U.S.C. § 79r(a) (1970); Investment Company Act of 1940, § 42(a), 15 U.S.C. § 80a-41(a) (1970); Investment Advisers Act of 1940, § 209(a), 15 U.S.C. § 80b-9(a) (1970).

19. Investigations are usually conducted confidentially by the SEC's regional offices unless proceedings are brought before the Commission as a matter of public record. In 1976 a total of 413 such investigations were opened. 42 SEC ANN. REP. 108 (1976).

responsibilities, the SEC has complete discretion in choosing among these remedies and may pursue several different remedies successively.[20]

*1. Summary Actions.*—Under certain SEC regulations[21] permitting exemption from the full registration requirements of the Securities Act of 1933[22] the SEC may temporarily suspend the exemption pending a hearing to determine whether such a suspension should be made permanent.[23] Unless subsequently modified, the effect of such a suspension is to permanently disqualify the issuer, underwriter, and principals of the exempted issuer from invoking the exemption in future offerings.[24] Similarly, under the Securities Exchange Act of 1934[25] the SEC has broad powers[26] to oversee the operation of national securities exchanges, over-the-counter markets, and self regulatory associations of these exchanges and markets. Thus, if it finds that such actions are in the public interest, the SEC may summarily suspend an issuer's over-the-counter or exchange trading.[27] In addition, the SEC may summarily revoke the registration of a self regulatory association and censure or place limits on its activities.[28]

*2. Criminal Referrals.*—Under each of the securities laws,[29] the SEC may refer its files to the Department of Justice with a recommendation for criminal prosecution.[30] If a *willful*[31] violation has oc-

20. *See* A.G. Bellin Securities Corp., 39 S.E.C. 178 (1959)(enforcement actions and administrative suspension proceeding may be instituted successively).

21. For example, the Commission's "Regulation A" provides an exemption from registration for certain domestic and Canadian issuers when the dollar amount of the offering does not exceed $500,000. Unlike other types of exemptions, however, regulation A requires the filing and processing of a notification statement with the appropriate SEC Regional Office, and the issuer must use an Offering Circular containing basic disclosure information in selling the securities. *See* 17 C.F.R. §§ 230.251-.263 (1976).

22. 15 U.S.C. §§ 77a-77aa (1970).

23. *See* 17 C.F.R. § 230.261 (1976)(relating to suspension of exemption pursuant to regulation A); *id.* §§ 230.334-.338 (relating to suspension of exemption pursuant to regulation B).

24. *See id.* § 230.252(c)-(e) (1976).

25. 15 U.S.C. §§ 78a-78jj (1970).

26. *See generally* Securities Exchange Act of 1934, §§ 15, 17, 19, 15 U.S.C. §§ 78o, 78q, 78s (Supp. 1975).

27. *See* Securities Exchange Act of 1934, §§ 15(c)(5) and 19(a)(4), 15 U.S.C. §§ 78o(c)(5) and 78s(h) (Supp. 1975).

28. Securities Exchange Act of 1934, 15 U.S.C. § 78s(h) (Supp. 1975).

29. Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1970); Trust Indenture Act of 1939, 321(a), 15 U.S.C. § 77uuu (1970); Securities Exchange Act of 1934, § 21(d), 15 U.S.C. § 78u(d) (Supp. 1975); Public Utility Holding Company Act of 1935, § 18(f), 15 U.S.C. § 79r(f) (1970); Investment Company Act of 1940, § 42(e), 15 U.S.C. § 80a-42(e) (1970); Investment Advisers Act of 1940, § 9(e), 15 U.S.C. § 80b-9(e) (1970).

30. In fiscal 1976, 116 cases were referred to the Department of Justice for prosecution, resulting in 97 convictions. 42 SEC ANN. REP. 206 (1976).

31. Because of the serious consequences following from a criminal conviction, each of the securities laws mandates that the defendant's conduct must amount to a "willful violation." Securities Act of 1933, § 24, 15 U.S.C. § 77x (1970); Trust Indenture Act of 1939, § 325, 15 U.S.C. § 77yyy (1970); Securities Exchange Act of 1934, § 32, 15 U.S.C. § 78ff (1970); Public Utility Holding Co. Act of 1935, § 29, 15 U.S.C. § 79z-3 (1970); Investment Company Act of 1940, §§ 37, 49, 15 U.S.C. §§ 80a-36, 80a-48 (1970); Investment Advisers

curred, the defendant is subject to both fines and imprisonment.[32]

*3. Administrative Enforcement Proceedings.*—Administrative enforcement proceedings are generally initiated by allegations of securities law violations by brokerage firms, dealers, or other persons engaged in the securities business. If the SEC determines from these proceedings that a willful[33] violation has occurred and that a sanction is in the public interest, it may revoke, suspend, or deny registration of a broker-dealer[34] or investment adviser[35] or censure or limit the activity of any person associated with a broker-dealer.[36] Administrative enforcement proceedings also deal with the adequacy of disclosure in registration statements[37] and reports[38] required to be filed with the SEC. These proceedings may result in a "stop order" suspending effectiveness of registration,[39] or an order directing compliance with the applicable reporting requirements.[40]

*4. Enforcement Actions.*—The enforcement action to enjoin securities law violations is the most common remedial measure employed by

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Act of 1940, § 217, 15 U.S.C. § 80b-17 (1970). While it is unnecessary to show that the defendant had the specific intent to violate the law, it must at least be shown that the defendant understood his actions and purposefully performed the acts that objectively constitute the violation. *See generally* James, *Culpability Predicates for Federal Securities Law Sanctions: The Present Law and the Proposed Federal Securites Code,* 12 HARV. J. ON LEGIS. 1 (1974).

32. Securities Act of 1933, § 24, 15 U.S.C. § 77x (1970) ($5,000 fine and/or 5 years' imprisonment); Trust Indenture Act of 1939, § 325, 15 U.S.C. § 77yyy (1970) ($5,000 fine and/or 5 years' imprisonment); Securities Exchange Act of 1934, § 32, 15 U.S.C. § 78ff (1970) (maximum fine of $500,000 for an exchange; $10,000 fine and/or 2 years' imprisonment for others); Public Utility Holding Company Act of 1935, § 29, 15 U.S.C. § 79z-3 (1970) (maximum fine of $200,000 for a public utility holding company, $10,000 fine and/or 2 years' imprisonment for others); Investment Company Act of 1940, § 49, 15 U.S.C. § 80a-48 (1970) ($10,000 fine and/or 2 years' imprisonment); Investment Advisers Act of 1940, § 217, 15 U.S.C. § 80b-17 (1970)($10,000 fine and/or 2 years' imprisonment).

33. "Willful violation" is generally required as the standard of proof for the imposition of administrative sanctions. *See* Securities Exchange Act of 1934, §§ 6(b), 8(a), 15(b)(5)(A), (D), and (E), 15(b)(7), and 15A(1)(2)(B), 15 U.S.C. §§ 78f(b), h(a), o(b)(5)(A), (D), and (E), o(b)(7) and o-3(1)(2)(B) (1970); Investment Company Act of 1940, §§ 17(h) and (i), 15 U.S.C. §§ 80a-17(h) and (i) (1970); Investment Advisers Act of 1940, §§ 203(e)(1) and (4), 203(f), 15 U.S.C. §§ 80b-3(e)(1) and (4), 80b-3(f) (1970). *See generally* James, note 31 *supra*.

34. Securities Exchange Act of 1934, § 15(b)(5), 15 U.S.C. § 78o(b)4 (Supp. 1975).

35. Investment Advisers Act of 1940, § 203(d), 15 U.S.C. § 80b-3(e) (1970).

36. Securities Exchange Act of 1934, § 15(b), 15 U.S.C. § 78o(b) (Supp. 1975).

37. Section 5 of the Securities Act of 1933 requires the filing of a registration statement with the SEC prior to any offers or sales of securities in interstate commerce. 15 U.S.C. § 77e (1970).

38. Sections 13 and 15(d) of the 1934 Act require issuers of securities registered under the 1933 Act or pursuant to Section 12 of the 1934 Act to file such reports as the SEC may prescribe. 15 U.S.C. §§ 78m, o(d) (1970). Pursuant to this authority the SEC by regulation requires (1) periodic reports to keep information on file with the SEC up to date, see 17 C.F.R. §§ 240.13a-11, 240.15d-11 (1976); (2) annual reports, *see id.* § 240.13a-1, 240.15d-1; (3) quarterly reports, *see id.* §§ 240.13a-13, 240.15d-13; and (4) other reports reflecting changed circumstances of the issuer, *see, e.g., id.* §§ 240.13a-10, 240.15d-10.

39. Securities Act of 1933, § 8(d), 15 U.S.C. § 77h(d) (1970).

40. Securities Exchange Act of 1934, § 15(c)(4), 15 U.S.C. § 78o(c)(4) (1970).

the SEC in rule 10b-5 violations.[41] Section 21(d) of the 1934 Act authorizes the SEC to seek injunctive relief in the appropriate federal district court whenever it appears that any person is engaged in, or about to engage in, securities laws violations.[42] Injunctive relief attained in an enforcement action has definite advantages over alternative enforcement options. It provides swift, decisive relief upon a prima facie showing of activity injurious to public investors.[43]

Moreover, once the equity jurisdiction of the court attaches, various forms of ancillary relief[44] may be granted under the traditionally inherent equity powers of the federal district courts.[45] In recent years the SEC has frequently requested and obtained increasingly varied forms of ancillary relief in rule 10b-5 enforcement actions.[46] Thus, enforcement actions have resulted in (1) appointment of equity receivers for businesses when investors were likely to be harmed by continuance of the existing management,[47] (2) disgorgement of wrongfully-obtained profits,[48] (3) ap-

41. During fiscal 1976 the SEC instituted 158 enforcement actions in the United States district courts. 42 SEC ANN. REP. 206 (1976).

42. Section 21(d) states in part as follows:

> Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

15 U.S.C. § 78u(d) (Supp. 1977).

43. To obtain preliminary relief in the form of a temporary restraining order or preliminary injunction, the SEC must show only that defendant's conduct constitutes a securities statute violation and that there is a reasonable likelihood that such violations will be repeated. *See* notes 53-60 and accompanying text *infra*.

44. Ancillary relief for securities law purposes can be characterized as an extra-statutory remedy imposed by an equity court to insure meaningful enforcement of its injunction decree.

45. Ancillary relief is granted under the traditional power of an equity court to implement its injunctive decrees, as well as the power of federal courts to formulate federal common law to effect statutory policy. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964). Although not specifically authorized by any of the securities laws, application of ancillary relief in enforcement actions is well established. Mills v. Electric Auto-Lite Co., 396 U.S. 3 (1970); American United Mut. Life Ins. Co. v. City of Avon Park, 311 U.S. 138 (1940); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

46. For a general discussion of the expanding trend of the SEC to request, and equity courts to grant, increasingly varied forms of ancillary relief, *see* Mathews, *Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunctive Actions*, 31 BUS. LAW. 1323 (1976); Sporkin, *SEC Developments Litigation and the Molding of Remedies*, 29 BUS. LAW. 121 (Special Issue, 1974); Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 WASH. & LEE L. REV. 637 (1975); Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 GEO. L.J. 737 (1976); Note, *Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5*, 79 HARV. L. REV. 656 (1966); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188 (1975).

47. *See, e.g.*, SEC v. Bowler, 427 F.2d 190 (4th Cir. 1970); SEC v. Keller Corp., 323 F.2d 397 (7th Cir. 1963); SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1971). While appointment of receivers in securities

pointment of independent boards of directors for corporate defendants,[49] and (4) imposition of additional disclosure requirements above those already mandated in the securites laws.[50]

Another advantage of the enforcement action is its tendency to induce a prompt, negotiated settlement evidenced by a consent decree between the SEC and the potential defendant. In a consent decree, the defendant and the SEC execute a "Stipulation and Consent to Final Judgment of Permanent Injunction" whereby defendant, usually without admitting or denying the allegations made by the SEC regarding the unlawful nature of his prior activity,[51] agrees to refrain from similar activity in the future and/or to amend his conduct so as to comply with the provisions of the securities laws. The agreement is then presented to the court, which enters a judicial decree after satisfying itself that the settlement is equitable and affords adequate public protection.[52]

The consent decree process is a virtual necessity for the SEC, since it has neither the time nor the resources to litigate each complaint to its ultimate judicial conclusion. Each party derives substantial benefit from negotiating a consent decree. By obtaining the decree, the SEC has served the public interest by bringing the allegedly violative conduct to a

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litigation has been effected for the most part through judicial initiative, section 42(e) of the Investment Company Act of 1940 specifically authorizes appointment of a receiver. 15 U.S.C. § 80a-41(c) (1970).

48. SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); SEC v. Penn Central Co., 425 F. Supp. 593 (E.D. Pa. 1976); SEC v. Commonwealth Chem. Secs., Inc., 410 F. Supp. 1002 (S.D.N.Y. 1976); SEC v. General Refractories Co., 400 F. Supp. 1249 (D.D.C. 1975).

49. *See, e.g.*, SEC v. Mattel, Inc., 5 SEC DOCKET 241 (Sec. Lit. Rel. No. 6531)(C.D. Cal. Oct. 2, 1974)(company required to maintain board of directors in which majority is selected by the SEC with court approval); SEC v. Coastal States Gas Corp., 2 SEC DOCKET 451 (Sec. Lit. Rel. No. 6054) (S.D. Tex. Sept. 12, 1973) (six independent directors appointed to an enlarged board of 13). *See generally* Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 GEO. L.J. 737 (1976).

50. *See, e.g.*, SEC v. Foremost-McKesson, Inc., 9 SEC DOCKET 1074 (Sec. Lit. Rel. No. 7479)(D.D.C. July 7, 1976)(company required to complete investigation by its Audit Committee and submit final written report); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973)(written guidelines for distribution of financial information to investors).

51. The usual language of the Stipulation and Consent, making clear that no statutory violation has been proven, states as follows:

> This Stipulation and Consent is entered into solely for the purpose of settlement of this action, without trial or argument of any issue of fact or law. Neither this Stipulation and Consent, nor the entry of judgment herein in accordance with the Final Judgment of Permanent Injunction in the form annexed hereto, shall constitute any evidence or any admission or any adjudication with respect to any allegation of the Commission's complaint or any fact or conclusion of law with respect to any matter alleged in or arising out of the Commission's complaint, or of any wrongdoing or misconduct on the part of [the defendant].

Treadway, *supra* note 46, at 639 n.15.

52. The role of the court in the consent decree process is to provide a judicial check on the administrative action of the SEC in agreeing to the terms of the consent settlement. Once entered, the consent decree is binding on the parties and can be appealed only on the grounds of fraud, lack of actual consent of a party, or lack of subject matter jurisdiction of the approving court. *See generally* SEC v. Thermodynamics, Inc., 319 F. Supp. 1380 (D. Colo. 1970), *aff'd*, 464 F.2d 457 (10th Cir. 1972), *cert. denied*, 410 U.S. 927 (1973); United States v. Carter Prod. Inc., 211 F. Supp. 144 (S.D.N.Y. 1962).

halt. At the same time, the defendant has averted the expense of extended litigation and the accompanying damaging publicity.

Because it is specifically a statutory remedy,[53] an enforcement action is not subject to all the equitable requirements necessary to sustain a private suit for injunctive relief.[54] The SEC need only establish that the defendant has committed, or is about to commit a violation of the securities laws, and that certain traditional notions of equity do not weigh against imposition of an injunction.[55] Thus, the SEC need not sustain the burden of showing inadequacy of legal remedies,[56] irreparable injury,[57] or continuing violation.[58] Nevertheless, the federal district courts retain wide discretion in weighing other equitable factors relating to the likelihood of future violations.[59] Unless the SEC can demonstrate that past violations are reasonably likely to be repeated, an injunction will be denied, despite the prima facie showing of securities law violations required by statute.[60]

## III. Scienter as an Enforcement Action Requirement

### *A. Prior to Hochfelder*

One of the elements[61] most frequently considered by courts in determining the reasonable likelihood of future violations is the degree of

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53. Each of the securities laws authorizes the SEC to seek injunctive relief in the appropriate district court. Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1970); Trust Indenture Act of 1939, § 321(a), 15 U.S.C. § 77uuu (1970); Securities Exchange Act of 1934, § 21(d), 15 U.S.C. § 78u(d) (Supp. 1975); Public Utility Holding Company Act of 1935, § 18(f), 15 U.S.C. § 79r(f) (1970); Investment Company Act of 1940, § 42(e), 15 U.S.C. § 80a-42(e) (1970); Investment Advisers Act of 1940, § 9(e), 15 U.S.C. § 80b-9(e) (1970).

54. *See* SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972).

55. *See* SEC v. Advance Growth Capital Corp., 470 F.2d 40 (7th Cir. 1972); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); SEC v. Frank, 388 F.2d 486 (2d Cir. 1968); SEC v. Geotek, 426 F. Supp. 715 (N.D. Cal. 1976).

56. Bradford v. SEC, 278 F.2d 566 (9th Cir. 1960); Walling v. Clinchfield Coal Corp., 129 F.2d 395 (4th Cir. 1946); SEC v. Jones, 85 F.2d 17 (2d Cir.), *cert. denied*, 299 U.S. 581 (1936).

57. SEC v. Torr, 87 F.2d 446 (2d Cir. 1937); SEC v. R.J. Allen Assocs., 386 F. Supp. 866 (S.D. Fla. 1974); SEC v. Mono-Kearsarge Consolidated Mining Co., 167 F. Supp. 248 (D. Utah 1958).

58. United States v. Parke Davis & Co., 362 U.S. 29 (1960); SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); Otis & Co. v. SEC, 106 F.2d 579 (6th Cir. 1939); SEC v. Dot, 302 F. Supp. 169 (S.D.N.Y. 1969).

59. SEC v. Universal Major Indus. Corp., 546 F.2d 1044 (2d Cir. 1976); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972).

60. *See, e.g.*, SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 831 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

61. Other factors generally considered by courts in measuring the likelihood of future violations include the following: (1) the isolated or recurrent nature of the violation, *see, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 835 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969); (2) the defendant's recognition of the wrongful nature of his conduct, *see e.g.*, SEC v. MacElvain, 417 F.2d 1134 (5th Cir. 1969), *cert. denied*, 397 U.S. 972 (1970); (3) the defendant's voluntary cessation of such activity, *see, e.g.*, SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); (4) the sincerity of assurances that no future violations will occur, *see, e.g.*, SEC v. National Student Mkting Corp., 402 F. Supp. 641 (D.D.C. 1975); and (5) the defendant's occupational opportunity for further violation, *see, e.g.*, SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970).

scienter in the defendant's past activity. The term scienter in securities litigation has defied precise definition. One commentator observes that "scienter . . . has been variously defined to mean everything from knowing falsity with an implication of *mens rea,* through the various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault . . . ."[62] Generally, courts have agreed that common law intent to defraud need not be shown in private damages actions, holding that some form of personal knowledge of the misrepresentations or omission beyond mere negligence is sufficient.[63]

Prior to the Supreme Court's decision in *Ernst & Ernst v. Hochfelder,*[64] courts almost unanimously regarded ordinary negligence as a sufficient standard of liability in an enforcement action.[65] Even circuits that required a scienter standard in private damages actions distinguished the enforcement action as a statutory form of remedial action for which a scienter requirement is inappropriate.[66] These holdings have been based on two grounds.

First, the inherent purposes underlying enforcement actions and private damages actions are clearly distinguishable. In private damages actions, the plaintiff/victim seeks personal monetary redress of past statutory violations. In enforcement actions, the SEC seeks injunctive protection for the public against future violations. Thus, while a stricter scienter standard may be justified when the recovery sought is of a compensatory or punitive nature, courts have refused to apply such a standard to the milder "prophylactic relief" sought in an enforcement action.[67]

Second, courts have used a public policy rationale to uphold a more flexible standard of liability in enforcement actions. The entire thrust of the securities laws is the protection of the economic public interest through disclosure requirements designed to enable public investors to

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62. 3 L. Loss, Securities Regulation 1432 (2d Ed. 1961).

63. *See, e.g.,* Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied,* 422 U.S. 1007 (1975)(scienter or conscious fault beyond mere negligence); Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970)(actual knowledge of falsity). Material misrepresentations or omissions made in reckless disregard of the truth have also been found sufficient in private suits. *See, e.g.,* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973). For a discussion of the judicial meaning of the scienter requirement, *see* notes 127-39 and accompanying text *infra.*

64. 425 U.S. 185 (1976).

65. *See* SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d cir. 1975); SEC v. Dolnick, 501 F.2d 1279 (7th Cir. 1974); SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970). *But see* SEC v. Coffey, 493 F.2d 1304 (6th Cir.), *cert. denied,* 420 U.S. 908 (1974).

66. *Compare* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973)(actual knowledge or willful disregard for the truth necessary in private suit) *with* SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) (scienter standard not relevant in enforcement actions).

67. *See, e.g.,* SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

make investment decisions based upon all material information. Because the investing public can be harmed just as much from negligent violations as from violations that entail scienter, courts have adopted a less restrictive standard of liability in enforcement actions to further the intended remedial purposes of the securities statutes.[68]

### *B. The Hochfelder Case*

The interpretive analysis used by the Supreme Court in *Ernst & Ernst v. Hochfelder*[69] casts considerable doubt on the vitality of the traditional justifications for a negligence standard of liability in enforcement actions. In *Hochfelder,* the plaintiffs, regular brokerage clients of First Securities Company of Chicago, brought a private suit under section 10(b) and rule 10b-5 against the accounting firm of Ernst & Ernst, which had been retained by First Securities from 1946 to 1967 to audit its books and to file certain annual reports with the SEC pursuant to section 17(a) of the 1934 Act.[70] For approximately twenty-six years plaintiffs had invested in "private escrow accounts"[71] set up by Leston B. Nay, president and 92% shareholder of First Securities. In 1968 Nay committed suicide, leaving a note in which he admitted that no such accounts existed, and that he had converted the plaintiffs' funds to his own use. Among other legal actions,[72] plaintiffs brought suit against Ernst & Ernst, alleging that the accounting firm's negligence[73] in failing to use adequate auditing procedures[74] to uncover Nay's fraudulent conduct constituted violations of section 10(b) and rule 10b-5.

In an unreported opinion the district court granted summary judgment to Ernst & Ernst. The court of appeals reversed the lower court,

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68. *See, e.g.,* SEC v. Capital Gains Research Bur., Inc., 375 U.S. 180 (1963); Hecht Co. v. Bowles, 321 U.S. 321 (1944).

69. 425 U.S. 185 (1976).

70. Section 17(a) requires that securities brokers or dealers "make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78q(a) (1970). Under rule 17a-5 in effect during the period under litigation, First Securities was required to file an annual report of its financial condition, accompanied by an accountant's statement that the financial audit was conducted in accordance with "generally accepted auditing standards applicable in the circumstances." 17 C.F.R. § 240.17a-5 (1976).

71. Plaintiffs were induced to invest in the private escrow accounts by personal assurances from Nay of a high interest yield on all moneys deposited. All deposits were to be made by personal checks payable to a designated bank for Nay's account and mailed directly to Nay, who would then allocate them to the proper escrow account. Similarly, Nay made direct interest payments to plaintiffs at periodic intervals.

72. Plaintiffs also brought suits against the Midwest Stock Exchange alleging that through its acts and omissions the Exchange had aided and abetted Nay's fraud. Summary judgment for the Exchange was affirmed on appeal. Hochfelder v. Midwest Stock Exchange, 503 F.2d 364 (7th Cir.), *cert. denied,* 491 U.S. 875 (1974).

73. Plaintiffs specifically disclaimed any intentional misconduct or fraud on the part of Ernst & Ernst, alleging only "inexcusable negligence." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 190 (1976).

74. Specifically, plaintiffs charged that proper auditing practices would have uncovered Nay's private "mail rule," whereby all contributions to the escrow accounts mailed to Nay's attention were not to be handled by anyone else at First Securities—even during Nay's absence on vacations. Discovery of the "mail rule" would have prompted investigation into the fraudulent escrow accounts.

ruling that the accounting firm was liable under rule 10b-5 for negligently aiding and abetting Nay's fraudulent scheme.[75] In reversing the appeals court judgment against Ernst & Ernst, the Supreme Court laid to rest the controversy among circuit courts[76] by squarely holding that proof of ordinary negligence is insufficient to establish liability in a private action for damages under rule 10b-5.[77] The Court used a four part analysis in reaching its decision.

First, the Court looked to the statutory language of section 10(b). In particular, the Court examined dictionary definitions[78] of such 10b-5 language as "manipulative," "device," and "contrivance" to demonstrate that each of these key terms comprehends a form of deliberate, knowing conduct. From the statutory inclusion of such terms evidencing an underlying purposeful intent, the Court concluded that the intent of Congress in choosing such language was "unmistakable" in proscribing a type of conduct "quite different from negligence."[79]

Second, the Court examined the legislative history of section 10(b) to support its conclusion that the statutory language was addressed to practices that reveal some element of scienter. The Court quoted at length statements made in congressional hearings and reports by spokesmen for the drafters of the 1934 Act.[80] From these statements the Court concluded that the overall congressional intent was to create a "catch-all" basis for private damage suits based on manipulative and deceptive practices.[81] Since this legislative history revealed no specific indication of congres-

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75. Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).

76. *See* note 9 *supra*.

77. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

78. The Court used the 1934 edition of Webster's International Dictionary to define these terms as follows:

> device—"[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme often, a scheme to deceive . . . ."
>
> contrive—"[t]o devise; to plan; to plot . . . invent . . . to scheme . . . ."
>
> manipulate—"to manage or treat artfully or fraudulently; as to *manipulate* accounts . . . ."

*Id.* at 199 nn.20-21 (1976).

79. *Id.* at 199 (1976).

80. The Court quoted the following statements as an indication of the legislative intent underlying Section 10(b):

> Of course subsection (c) [and 10(b) when enacted] is a catchall clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices.

*Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran), *quoted in* 425 U.S. at 202-03.

> [T]he bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements . . . shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false of misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in *good faith*. [emphasis supplied by the Court]

S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934), *quoted in* 425 U.S. at 205-06.

81. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207 (1976).

sional intent to impose liability for illicit practices based on good faith, the Court determined that the statutory language should not be judicially interpreted more broadly.[82]

Third, the Court compared the language of section 10(b) with other sections of the 1933 and 1934 Acts that impose civil liability on securities law violators.[83] In each of these sections there is a clear indication whether civil liability is to be imposed for "knowing or intentional conduct, negligence, or entirely innocent mistake."[84] Moreover, in each section in which a negligence standard of liability is clearly intended, certain procedural restrictions are grafted into the statutory remedy.[85] No such procedural restrictions impair section 10(b) actions; consequently, the Court concluded that the judicially created private damages action under section 10(b) could not be based on negligent wrongdoing.[86]

Last, the Court examined rule 10b-5 in light of the analysis used for section 10(b). Since neither the plain language nor the legislative history of section 10(b) was found to support a less than scienter standard of liability, and since the scope of rule 10b-5 is limited by the statutory section pursuant to which it is promulgated, the Court concluded that application of rule 10b-5 is limited to behavior that includes some degree of scienter.[87]

An interpretation of the effect of the *Hochfelder* decision on the standard of liability in enforcement actions must take into consideration that the Court's ruling was limited in scope to private damages actions under rule 10b-5. The Court explicitly left open the question whether scienter would be required in an enforcement action.[88] Additionally, the decision seemed to leave room for further judicial refinement of the exact meaning of scienter by failing to address the issue of recklessness as a

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82. *Id.*

83. Specifically, the Court examined sections 11, 12, and 15 of the 1933 Act, which impose civil liability for false or misleading registration statements, prospectuses, or oral communications relating to the sale of securities. 15 U.S.C. §§ 77k, 77l, 77o (1970). The Court similarly looked at sections 9, 18, and 20 of the 1934 Act, which impose civil liability for manipulation of securities prices and for false or misleading statements in any application, report, or document filed with the SEC. 15 U.S.C. §§ 78i, 78r, 78t (1970). *See* 425 U.S. at 206-11.

84. 425 U.S. at 207. Section 11 of the 1933 Act creates a private cause of action for a false and misleading registration statement. Although issuers of securities using such a registration statement are absolutely liable for resulting civil damages, experts such as accountants or lawyers used in preparing the statement are accorded a "due diligence" defense, which is comparable to a negligence standard of liability.

85. For example, in private damages actions under sections 11, 12, and 15 of the 1933 Act, the court may require the plaintiff to post a bond for costs. Similarly, a one year statute of limitations is made applicable to these provisions by section 13 of the 1933 Act.

86. The Court posited that an extension of section 10(b) to include actions based on negligent conduct "would allow causes of action covered by § 11, § 12(2), and § 15 of the 1933 Act, which are subject to procedural restrictions to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." 425 U.S. at 210.

87. *Id.* at 214.

88. *See* note 10 *supra*.

substitute for scienter.[89] As a result, lower courts seeking to apply the *Hochfelder* precedent to enforcement actions are initially confronted with two unresolved issues: Is the Court's scienter analysis applicable to enforcement actions? If it is to be applied, will a showing of reckless disregard for the truth be sufficient to satisfy a scienter standard?

### *C. Post-Hochfelder Interpretations*

Because the *Hochfelder* decision is of recent vintage and because the vast majority of enforcement actions terminate in consent decrees prior to final litigation on the merits,[90] few courts have confronted these issues. Moreover, those courts interpreting the *Hochfelder* scienter standard in the context of enforcement actions have rendered conflicting decisions.

In *SEC v. Bausch & Lomb, Inc.*,[91] the District Court for Southern New York[92] discarded the traditional distinctions between private damages actions and enforcement actions to require that the SEC plead and prove scienter in enforcement actions under rule 10b-5. Relying on the language[93] and legislative history[94] analyses of the *Hochfelder* opinion, the district court determined that neither the statutory language of section 10(b) nor the underlying legislative documents examined by the *Hochfelder* court evidences a congressional intent to set different standards of liability for private damages actions and enforcement actions.[95] Section 10(b) does not expressly create a civil remedy for its violation, and there is considerable evidence that a private cause of action was contemplated by neither the drafters of section 10(b)[96] nor by the SEC when it adopted rule 10b-5.[97] Although private damages actions under rule 10b-5 are now well established,[98] such actions are judicially recognized on the basis of

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89. The Court explicitly refused to take a position with respect to the sufficiency of recklessness as a scienter substitute.

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question of 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.

90. *See* notes 51-52 and accompanying text *supra*.

91. 420 F. Supp. 1226 (S.D.N.Y. 1976).

92. The District Court for Southern New York bears the brunt of voluminous securities law litigation due to its geographical area of jurisdiction, which includes the corporate financial hub of New York City. Consequently, both the district court and the Second Circuit Court of Appeals have achieved a judicially recognized degree of specialization in securities litigation, which is accorded a certain deference and attention by other jurisdictions.

93. *See* notes 78-79 and accompanying text *supra*.

94. *See* notes 80-82 and accompanying text *supra*.

95. 420 F. Supp. at 1240-41.

96. *See* S. Rep. No. 792, 73d Cong., 2d Sess. 5-6 (1934); Note, *Implied Liability Under the Securities Exchange Act*, 61 HARV. L. REV. 858 (1948).

97. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); SEC Release No. 3230 (May 21, 1942).

98. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

an implied statutory liability.[99] Consequently, the district court reasoned that the Supreme Court's language and legislative hsitory analyses in *Hochfelder,* a judicially implied form of action, must apply with equal force to the enforcement action originally contemplated by the drafters of section 10(b) and rule 10b-5. As a result the court concluded that "the identical standard under § 10(b) and Rule 10b-5 must be applied whether the plaintiff is the SEC or a private litigant."[100]

In applying the *Hochfelder* rationale to enforcement actions, the district court refused to draw on public policy considerations to distinguish enforcement actions from private damages actions. Observing that only traditional public policy arguments could support a negligence standard for enforcement actions and that the *Hochfelder* opinion explicitly refused to entertain such arguments in a private damages action,[101] the district court similarly concluded that public policy considerations were inapposite to a determination of the requisite standard of liability in enforcement actions.[102]

In *SEC v. American Realty Trust,*[103] the Eastern District of Virginia followed the reasoning of the *Bausch & Lomb* court by declaring scienter to be a necessary element in both enforcement and private damages actions.[104] Additionally, the court broadened the *Hochfelder* scienter requirement to include actions brought under Section 17 of the 1933 Act.[105]

Application of the *Hochfelder* scienter standard to enforcement actions has not met with universal acceptance. In *SEC v. Universal Major Industries Corp.,*[106] the Second Circuit declined to extend the

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99. Probably the first judicial decision recognizing an implied civil liability under section 10(b) is Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). Since *Kardon,* there has been a steady expansion of judicial recognition of private suits under both section 10(b) and rule 10b-5. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Supreme Court characterized this expansion as follows: "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn." *Id.* at 729-30. For a discussion and synopsis of the judicial development of civil liability under section 10(b) and rule 10b-5, see North, *Implied Liability Cases Under the Federal Securities Laws,* 4 CORP. PRAC. COMMENTATOR 1 (1962).

100. 420 F. Supp. at 1243 n.4.

101. The Supreme Court stated, "As we find the language and history of § 10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of 'policy,' set forth by the parties . . . ." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976).

102. 420 F. Supp. at 1241.

103. 429 F. Supp. 1148 (E.D. Va. 1977).

104. The court stated, "If the language and history of 10(b) is dispositive as to a scienter requirement in private actions, it must also be so for SEC enforcement actions, since such suits are creatures of statute rather than implied rights of action." *Id.* at 1171.

105. The Court reasoned as follows:

> Both antifraud provisions—§ 10(b) of the 1934 Act, and § 17 of the 1933 Act—contain almost identical language, a fact which even the SEC has admitted . . . . Both provisions have similar purposes. Accordingly the Court concludes that scienter—an intent to deceive, manipulate, or defraud—is also a necessary element in an action for injunctive relief brought by the SEC pursuant to § 17(a) of the Securities Act of 1933.

*Id.*

106. 546 F.2d 1044 (2d Cir. 1976).

*Hochfelder* analysis to enforcement actions. Although the court of appeals affirmed the lower court's finding that the defendant-appellant possessed the requisite degree of scienter required by *Hochfelder* for private damages actions, dictum in the appellate court's opinion made it clear that it did not believe the *Hochfelder* decision undermined the prior case law of the circuit,[107] which established negligence as the proper standard of liability in enforcement actions.[108]

A similar decision was reached by the First Circuit in *SEC v. World Radio Mission, Inc.*[109] Stressing the underlying difference in purpose between a private suit and an enforcement action, the court stated,

> 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 [citations omitted], should make no difference. . . . An injunction is designed to protect the public against conduct, not to punish a state of mind.[110]

The same reasoning has been adopted in dictum by other courts in enforcement actions decided subsequent to *Hochfelder.*[111]

### *D. Should Scienter Be Required in Enforcement Actions?*

Notwithstanding the district court's use of the *Hochfelder* analysis in *SEC v. Bausch & Lomb, Inc.*[112] to require a scienter standard in enforcement actions under rule 10b-5, it seems clear that *Hochfelder* does not compel this result. While the Supreme Court did not consider public policy considerations necessary for an analysis of scienter in private damages actions[113] these considerations are crucial to the determination of a liability standard in enforcement actions.[114] When public policy is considered, the overwhelming weight of judicial authority[115] would apply a traditional negligence standard to enforcement actions.

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107. The Second Circuit has required a scienter standard for private suits under rule 10b-5, but has consistently rejected scienter as a prerequisite for injunctive relief in enforcement actions. *Compare, e.g.,* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) *with* SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) *and* SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975).

108. SEC v. Universal Major Indus. Corp., 546 F.2d 1044 (2d Cir. 1976).

109. 544 F.2d 535 (1st Cir. 1976).

110. *Id.* at 540-41.

111. *See* SEC v. Geotek Resources Fund, Inc., 426 F. Supp. 715 (N.D. Cal. 1976); SEC v. Galaxy Foods, Inc., 417 F. Supp. 122 (E.D.N.Y. 1976) (although defendant showed reckless disregard for truth sufficient to establish scienter, negligence alone is sufficient for SEC injunctive relief); SEC v. Trans Jersey Bancorp., [Current] FED. SEC. L. REP. (CCH) ¶ 95818 (D.N.J. 1976) (although claim for monetary damages requires proof of scienter and causation, such elements are not required in an SEC injunctive action).

112. 420 F. Supp. 1226 (S.D.N.Y. 1976). *See* notes 91-102 and accompanying text *supra.*

113. *See* note 101 and accompanying text *supra.*

114. *See* Hecht Co. v. Bowles, 321 U.S. 321 (1944) (standards of public interest not the requirements of private litigation measure the propriety and need for injunctive relief); *accord,* SEC v. Capital Gains Research Bur., 375 U.S. 180 (1963).

115. *See* notes 65-66 and accompanying text *supra.*

Enforcement actions are distinct from both criminal and civil litigation. In a criminal proceeding the public policy presumption of innocence weighs the scales of justice heavily in favor of the defendant. Accordingly, the government must show a "willful" violation of the securites laws by the defendant,[116] and, thus, evidence sufficient to sustain an enforcement action may fall short of supporting a criminal conviction. In a private damages action the plaintiff properly bears a heavy burden of proving scienter, since he is representing his own financial interests. In an enforcement action, however, the SEC is acting in the public interest. Because an enforcement action is uniquely different from both a criminal proceeding and a private damages action, it should not automatically be subject to the same burden of proof requirements.

Moreover, unlike either a criminal action or a private suit, an enforcement action results in no stronger penalty than future compliance with the securities laws. Neither civil penalty in the form of damages nor criminal penalty in the form of fines and/or imprisonment is imposed, although violation of an injunctive decree may result in civil or criminal contempt proceedings.[117] Even when some form of ancillary relief is authorized,[118] it is imposed only to give effect to the remedial purposes of the statute and not to penalize or punish the defendant.[119]

Another factor militating against extension of the *Hochfelder* scienter standard to enforcement actions is the effect that such an extension is likely to have on the consent decree process. An indirect but important advantage of the enforcement action lies in its use as a bargaining lever in encouraging potential defendants to enter into informal negotiations that result in consent judgments.[120] By requiring the SEC to assume the onerous burden of proving scienter in an enforcement action, courts will weaken the SEC's bargaining position by encouraging potential defendants to go to the litigational mat in the belief that the SEC will be unable to meet the requirement.

Finally, in determining the applicability of the scienter requirement to enforcement actions, the *Hochfelder* decision should be interpreted as the latest in a continuing series of Supreme Court opinions evidencing a judicial trend toward confining the proliferation of securities litigation[121]

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116. *See* note 31 and accompanying text *supra*,

117. *See, e.g.,* Frank v. United States, 395 U.S. 147 (1969) (criminal contempt); Penfield Co. of California v. SEC, 330 U.S. 585 (1947) (civil contempt).

118. *See* notes 44-50 and accompanying text *supra*.

119. *See, e.g.,* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied,* 366 U.S. 919 (1971); SEC v. Beisinger Indus. Corp., 421 F. Supp. 691 (D. Mass. 1976).

120. *See* notes 51-52 and accompanying text *supra*.

121. *See, e.g.,* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (requiring purchaser-seller status by a private plaintiff to recover damages under rule 10b-5); Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975) (requiring showing of irreparable injury and inadequacy of legal remedy for private plaintiff seeking civil injunction under 13(d) of the 1934 Act); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053

and toward reducing the increasing workload of the federal judiciary by limiting access of private litigants to the federal courts.[122] Yet, decisions within this trend have clearly differentiated federal enforcement agencies from private litigants. In *Blue Chip Stamps v. Manor Drug Stores,*[123] for example, the Supreme Court restricted the availability of a rule 10b-5 civil remedy by requiring that the private plaintiff be a purchaser or seller of securities in connection with the allegedly unlawful conduct of the defendant.[124] The Court, however, affirmed an earlier opinion,[125] declaring that no such limitation is imposed on the SEC in an enforcement action.[126] The *Hochfelder* Court's explicit refusal to include enforcement actions within the scope of its scienter formulation provides an implicit indication that the Court's rationale should be restricted to private damages action under rule 10b-5.

## IV. The Meaning of Scienter

### *A. Scienter Prior to Hochfelder*

The second problem facing courts that apply the *Hochfelder* scienter standard to enforcement actions is defining the type of conduct necessary to demonstrate scienter by the defendant. Although some form of scienter was required by most circuit courts prior to *Hochfelder,*[127] the precise nature of the conduct embraced by the term scienter has been shrouded in semantic confusion.[128] Indeed, there are almost as many formulations of the meaning of scienter as there are judicial decisions employing the term.[129] Traditionally, scienter encompasses the following four elements

(1977) (restricting 10b-5 liability for insider trading on open market when no direct reliance can be shown by plaintiff).

122. *See, e.g.,* Cort v. Ash., 422 U.S. 66 (1975) (denying an implied civil cause of action to prohibit illegal campaign contributions); Alyeska Pipeline Service Co. v. Wilderness Society, 421 U.S. 240 (1975) (limiting awarding of attorneys' fees in private suits to enforce remedial statutes).

123. 421 U.S. 723 (1975).

124. By imposing a purchaser-seller requirement, the Court affirmed the "Birnbaum Doctrine" of the landmark decision of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952). In that decision the court dismissed the plaintiff's private suit under rule 10b-5 for lack of standing, since plaintiff had not actually purchased or sold securities.

125. In SEC v. National Securities, Inc., 393 U.S. 453 (1969), the Court held that the purchaser-seller rule imposed no limitation on the SEC in bringing enforcement actions for injunctive relief.

126. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 751 n.14 (1975).

127. *See* note 9 *supra*.

128. This judicial confusion has prompted one commentator to state, "Probably the most important step toward clarifying the law of scienter would be to ban the word." 2 A. BROMBERG, SECURITIES LAW: FRAUD SEC RULE 10b-5, § 8.4, at 503 (Supp. 1971)[hereinafter cited as A. BROMBERG].

129. The scienter terminology has been judicially construed to include conduct ranging from ordinary negligence to willful fraud. *See* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971) (knowledge of falsity or reckless disregard for the truth); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (concurring opinion) (recklessness equivalent to willful fraud); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965) (common-law fraud not required); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951) (proof of fraud necessary to establish scienter).

of fraudulent intent: (1) that a representation be made, (2) that it convey a particular meaning, (3) that it be believed, and (4) that it be acted upon in a certain manner.[130] In the early case of *Derry v. Peek,*[131] an English court held that "fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false."[132] This classic common-law formulation has been adapted to securities litigation to establish scienter based on the defendant's knowledge, state of mind, or degree of care in making a misleading statement or omission.[133]

The knowledge criterion is the most widely used of the three bases and the standard favored by many commentators.[134] As it has judicially evolved in rule 10b-5 litigation, knowledge has come to mean either actual knowledge by the defendant that a statement is misleading or knowledge of the existence of facts which, if disclosed, would have shown the statement or omission to be misleading.[135] Many courts have extended the knowledge criterion to include "constructive knowledge"—*i.e.,* knowledge of the misleading nature of a statement or omission that is imputed from the factual data available to the defendant at the time.[136]

In contrast to the objective knowledge criterion, the state of mind criterion requires subjective inquiry into the defendant's motive, purpose, or intent in making the misleading statement or omission. Although this is the strictest of the scienter criteria, some courts have inferred intent to deceive from a showing of actual or constructive knowledge of facts indicating the misleading nature of the statement or omission.[137] Moreover, the state of mind criterion is sometimes presented as an alternative form of scienter proof to be used in conjunction with knowledge or care criteria.[138]

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130. W. PROSSER, LAW OF TORTS 700 (4th ed. 1971).

131. 14 A.C. 337 (1889).

132. *Id.* at 374.

133. In addition to the three broad common-law criteria for establishing scienter, Professor Bromberg refines the degrees within each category as follows:

Knowledge criteria
- Actual knowledge
- Constructive knowledge

State of mind criteria
- Intent
- Purpose or motive
- Bad faith

Care Criteria
- Recklessness
- Negligence

A. BROMBERG, *supra* note 128, at 504.

134. *See, e.g., id.*; Bucklo, *Scienter and Rule 10b-5,* 67 NW. U.L. REV. 562 (1972); Comment, *Scienter and Rule 10b-5,* 69 COLUM. L. REV. 1057 (1969).

135. *See, e.g.,* Rochez Bros. Inc. v. Rhoads, 491 F.2d 402 (3d Cir. 1974); McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976).

136. *See* Cohen v. Franchard Corp., 478 F.2d 115 (2d Cir. 1973); Hert v. Weitzen, 402 F.2d 909 (2d Cir. 1968); Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1965).

137. *See, e.g.,* Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962) (intent to deceive may be inferred from knowledge).

138. *See, e.g.,* Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

The care criterion comes closest to the traditional negligence standard of liability. Many courts unwilling to allow recovery in private suits for "mere negligence" nevertheless impose liability when the defendant's conduct amounts to a reckless disregard for the truth.[139] Although recklessness in the context of securities litigation has not been very clearly defined, it has generally included conduct falling short of a fully formed intent to deceive, yet amounting to more than ordinary negligence.[140]

### *B. The Meaning of Scienter in Hochfelder*

It is from this confusing range of scienter formulations that the Supreme Court fashioned its scienter requirement for private damages actions under rule 10b-5. The *Hochfelder* definition of scienter—"mental state embracing an intent to deceive, manipulate or defraud"[141]—contributes little to the refinement of the degree of culpability required. By adopting the most restrictive of the three traditional scienter criteria, the Supreme Court mandated an admittedly confused judicial standard while failing to provide the conceptual tools necessary for its further refinement in the lower courts.

The *Hochfelder* opinion added a further element of confusion by refusing to eliminate recklessness as an adequate substitute for scienter.[142] As might be expected, this has created an interpretational split in the lower courts. The Southern District of New York, which now seems to require scienter in enforcement actions,[143] has determined that only

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139. *See id.*; Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971); McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976).

140. One court has formulated the meaning of recklessness in the context of rule 10b-5 litigation as follows:

> In determining was [sic] constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort.

Lanza v. Drexel & Co., 479 F.2d 1277, 1306 n.98 (2d Cir. 1973).

A more recent interpretation of the meaning of recklessness in post-*Hochfelder* securities litigation relies on the more restrictive state of mind criterion. In Franks v. Midwestern Oklahoma Development Auth., 428 F. Supp. 719 (W.D. Okla. 1976), the court defined reckless conduct as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* at 725. This interpretation has been termed a "functional equivalent of intent" by one court. Sundstrand Corp. v. Sun Chemical Corp., 533 F.2d 1033, 1045 (7th Cir. 1977).

141. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976).

142. The *Hochfelder* Court stated,

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

*Id.* at 194 n.12.

143. While the *Bausch & Lomb* decision explicitly required scienter in an SEC enforcement action, *see* notes 89-103 and accompanying text *supra*, that result has been put in doubt by a recent decision handed down by a different panel of the district court. In SEC v.

recklessness equivalent to willful fraud is sufficient to satisfy the scienter requirement.[144] Other courts, however, have determined that recklessness equivalent to knowledge will suffice.[145]

A similar divergence of opinion is reflected in recent lower court decisions in private damages actions brought under rule 10b-5. Some courts that require strict adherence to the state of mind criterion established in *Hochfelder* have held recklessness insufficient to demonstrate scienter.[146] Other courts have accepted recklessness as a scienter substitute, but have differed over what constitutes reckless behavior.[147]

### C. *Meaning of Scienter in Enforcement Actions*

Although the state of mind criterion for establishing scienter has been mandated by *Hochfelder* in private damages actions, it does not necessarily follow that the same criterion must be applied in an enforcement context.[148] The opinion itself left ample room for the development

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E.L. Aaron & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 96,043 (S.D.N.Y. 1977), the defendant relied on the *Bausch & Lomb* precedent to argue that the SEC must establish scienter as part of its burden of proof in an enforcement action. The court countered,

> *Hochfelder* only passed upon a private suit for damages in a § 10(b) context and not upon Commission injunctive actions under § 5. The law of this Circuit is that negligence, and not scienter, is all that is required in a Commission injunctive proceeding under § 5. [citing *Universal Major Indus.* opinion of the Second Circuit]. However, even if scienter were required, defendants acted with knowledge or reckless disregard of the illegality of the arrangement.

*Id.* at 91,686.

144. SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226, 1242-43 n.4 (S.D.N.Y. 1976). This interpretation has been specifically endorsed in a recent decision of the District Court for the Eastern District of Virginia. In SEC v. American Realty Trust, 429 F. Supp. 1148 (E.D. Va. 1977) the court stated,

> The Supreme Court's emphasis that scienter means to deceive leads this Court to agree with the conclusion, reached by the District Court in *Bausch & Lomb, supra*, that "only what Judge Friendly has characterized as 'the kind of recklessness that is equivalent to willful fraud' [citation omitted] will serve as a basis for liability."
>
> One decision subsequent to *Hochfelder, McLean v. Alexander,* 420 F. Supp. 1057 (D. Del. 1976), has indicated that knowing conduct is to be equated with scienter, but this Court declines to follow that decision.

*Id.* at 1171 n.8.

145. *See, e.g.,* SEC v. E.L. Aaron & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 96,043 (S.D.N.Y. 1977) (*see* note 143 *supra*); SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225 (E.D.N.Y. 1976).

146. *See* Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164 (10th Cir. 1977) (willful or intentional misconduct or the equivalent thereof essential to recovery); Straub v. Vaisman & Co., 540 F.2d 591 (3d Cir. 1976) (specific intent to defraud satisfying *Hochfelder* scienter requirement); Franks v. Midwestern Oklahoma Development Auth., 428 F. Supp. 719 (W.D. Okla. 1976) (conscious fault or actual knowledge necessary).

147. *Compare* Coleco Indus., Inc. v. Berman, 423 F. Supp. 275 (E.D. Pa. 1976) (private suit dismissed when no intent or recklessness equivalent to fraud shown) *and* Mallinckrodt Chemical Works v. Goldman Sachs & Co., 420 F. Supp. 231 (S.D.N.Y. 1976) (recklessness equivalent to willful fraud sufficient) *with* Peltz v. Northern Ohio Bank, 430 F. Supp. 382 (N.D. Ohio 1977) (actual knowledge or reckless disregard for the truth) *and* McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976) (little reason to distinguish between knowing misbehavior and reckless misbehavior).

148. *But see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 215 (1976) (Blackmun, J., dissenting). In dissenting to the majority imposition of a scienter standard for private suits, Mr. Justice Blackmun stated,

> [T]he 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.

of a less restrictive formulation of scienter in enforcement actions by injecting the element of recklessness as a substitute for scienter. Moreover, existing case law has always recognized inherent differences between private damages and enforcement actions,[149] and therefore supports development of a separate scienter meaning in the latter.

Many of the same considerations that militate against imposition of a scienter standard in enforcement actions argue just as persuasively against interpreting such a standard restrictively. Because the enforcement action is remedial rather than punitive, a less restrictive scienter formulation is warranted. The public interest in SEC enforcement of securities laws requires flexible interpretation of burden of proof formulations to effect the remedial purposes of these statutes.[150] Moreover, the SEC's administrative ability to enforce violations of the securities laws through the consent decree process would be jeopardized if a defendant thinks it unlikely that the SEC will be able to meet the burden of a technically restrictive scienter formulation.

Thus, in the context of enforcement actions, scienter should assume a more comprehensive meaning than in private suits. Rather than being restricted to a subjective intent to deceive, scienter should also comprise knowledge by a defendant that his conduct is misleading and conduct that amounts to a reckless disregard for the truth. By interpreting scienter as either actual knowledge or recklessness for purposes of enforcement actions, courts will provide the flexible framework necessary for effective enforcement of the securities laws.

## V. Conclusion

As the administrative agency charged with the enforcement of the securities laws, the SEC has a broad range of remedial options. One of the most effective and often used of these remedies is the enforcement action to enjoin future violations of section 10(b) and rule 10b-5. Prior to the Supreme Court's *Hochfelder* decision, negligence rather than scienter was the judicially accepted standard of liability in enforcement actions. Any extension of the scienter requirement to enforcement actions flies in the face of a judicially recognized public interest in effective enforcement of securities laws.

Even if the *Hochfelder* scienter standard is to be applied to enforcement actions, the meaning of scienter should be expanded beyond the restrictive state of mind criteria enunciated by the *Hochfelder* court for private suits. The *Hochfelder* decision's definitional ambiguity regarding

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*Id.* at 216. One court has used this reasoning to require scienter in enforcement actions since that standard is required in private suits. *See* SEC v. American Realty Trust, 429 F. Supp. 1148, 1171 (E.D. Va. 1977).

149. *See* notes 65-68 and accompanying text *supra*.

150. *See* SEC v. Capital Gains Research Bur., Inc., 375 U.S. 180 (1963).

the sufficiency of recklessness as a substitute for intentional deception leaves ample room for an interpretation that scienter includes conduct that the defendant knows to be misleading or that flows from reckless disregard for the truth. Such a construction is essential to assure judicial flexibility in furthering the remedial purposes of the securities laws in enforcement actions.

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