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John A. Occhipinti

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SECTION 18 OF THE SECURITIES EXCHANGE ACT OF 1934: PUTTING THE BITE BACK INTO THE TOOTHLESS TIGER

INTRODUCTION

In a series of recent decisions, the Supreme Court has tolled a new era in the field of federal securities law by abruptly halting the expansion of the implied private action arising under section 10(b) of the Securities Exchange Act of 1934¹ and its complementary provision, rule 10b-5.² It is now clear that section 10(b) and rule 10b-5 are no longer to be considered the cure for all evils in the securities market.³ As a result, other sections of the 1934 Act should take on added importance. Unfortunately, some of these sections have lost much of their vitality because of a lack of use during the period of section 10(b)'s vast expansion, and thus are in need of substantial reexamination and, perhaps, revision in light of the purpose of the Act—the protection of the public investor.⁴

Section 18(a) of the 1934 Act⁵ is a classic example of a provision that has been virtually unused since its enactment. Section 18(a) expressly provides that any person who makes false or misleading statements in a document filed with the Securities and Exchange Commission (SEC) will be liable to anyone who, in reliance on those statements, purchases or sells a security whose price was affected by the statements.⁶ While section 18(a) is an express liability provision dealing with specific abuses, section 10(b) is a general proscription against the use of any manipulative device or contrivance in connection with the purchase or sale of a security.⁷ Although section 10(b) is directed at

1. 15 U.S.C. § 78j(b) (1976).

2. 17 C.F.R. § 240.10b-5 (1977).

3. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (rule 10b-5 not applicable to breach of corporate fiduciary duty involving neither manipulation nor deception); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (§ 10(b) not applicable to misrepresentation by competing tender offeror); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (§ 10(b) and rule 10b-5 not applicable to negligent misstatements or omissions); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (§ 10(b) and rule 10b-5 not applicable to plaintiffs who are neither purchasers nor sellers of securities).

4. See 15 U.S.C. § 78b (1976).

5. *Id.* § 78r(a) (1976).

6. Section 18(a) provides: "Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . . , which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person . . . who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant." *Id.*

7. Section 10(b) provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a

different abuses,⁸ courts have nevertheless frequently implied a cause of action under the section in favor of plaintiffs alleging that documents filed with the SEC contained false or misleading statements,⁹ liability for which is expressly provided for by section 18(a). By expanding section 10(b) in this way, the courts have negated the need for section 18(a) and have, in effect, rendered it superfluous.

This judicial desire to use section 10(b) rather than section 18(a) is perhaps explained by the fact that the little case law which does exist under section 18(a) has generally interpreted the statute in a manner that makes it difficult for plaintiffs to recover.¹⁰ Courts have held that a plaintiff asserting a cause of action under section 18(a) must prove actual rather than constructive reliance.¹¹ In addition, the statute is, by its own terms, applicable only to documents filed with the SEC,¹² and thus only "the diligent few who peruse filed corporate reports"¹³ can assert a claim under this section. Most investors never even see, much less read, these documents.¹⁴ When these two prerequisites are viewed together, recovery under section 18(a) becomes virtually impossible. Because the documents are unread, there can be no actual reliance.

This Note will argue that any deficiencies in the ability of section 18(a) to protect the public investor can be cured by a more realistic interpretation of the section itself and not by the use of section 10(b), which was designed to cover different abuses. Part I will examine the recent Supreme Court decisions interpreting section 10(b) and the legislative history of the 1934 Act, and will conclude that section 18(a) should be the exclusive remedy for plaintiffs alleging a purchase or sale of securities made in reliance on false or misleading statements made in documents filed with the SEC. Part II will suggest how section 18(a) can be revitalized, a necessary step if it is to play an effective role in regulating securities frauds and protecting unwary investors.

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 [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (1976).

8. See notes 84-86 *infra* and accompanying text.

9. See *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977); *Seiden v. Nicholson*, 69 F.R.D. 681 (N.D. Ill. 1976); *Kramer v. Scientific Control Corp.*, 365 F. Supp. 780 (E.D. Pa. 1973); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967); *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33 (E.D. Pa. 1964). See generally *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

10. See, e.g., *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969). See also A. Jacobs, *The Impact of Rule 10b-5 § 3.02[h]* (rev. ed. 1978); 3 L. Loss, *Securities Regulation 1751-54* (2d ed. 1961).

11. *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *Barotz v. Monarch Gen., Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,933, at 97,237 (S.D.N.Y. 1975).

12. See note 6 *supra*.

13. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 745 (1975).

14. See Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340, 1359-60 (1966).

I. THE CASE FOR EXCLUSIVITY

A. *The Rise and Fall of Section 10(b)*

The growth of rule 10b-5 litigation has bordered on the spectacular. Although section 10(b) did not by its terms create an express private remedy for its violation, and there is no indication that Congress,¹⁵ or the SEC when adopting rule 10b-5,¹⁶ contemplated such a remedy, a private cause of action for violations of the statute and the rule was soon implied in *Kardon v. National Gypsum Co.*,¹⁷ and its existence is now well established.¹⁸ The private action under the rule has been referred to as "a judicial oak which has grown from little more than a legislative acorn."¹⁹ Over the years, rule 10b-5 developed into a potent remedy used to proscribe a wide variety of frauds in connection with securities transactions.²⁰ The rule was used to outlaw misrepresentations and omissions of material facts in various written and oral statements,²¹ corporate mismanagement,²² insider use of nonpublic material information,²³ and objectionable activities of broker-dealers and other

15. See S. Rep. No. 792, 73d Cong., 2d Sess. 5-6 (1934), reprinted in 5 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, Item 17, at 5-6 (1973) [hereinafter cited as Legislative History]. This report makes no mention of an express civil remedy.

16. See SEC Securities Exchange Act Release No. 3230 (May 21, 1942). This release is similarly void of any reference to the creation of an express civil remedy.

17. 69 F. Supp. 512 (E.D. Pa. 1946).

18. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

19. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

20. Rule 10b-5 provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(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 statement 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 (1977).

21. See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971) (deceptively gloomy press release concerning mineral exploration by corporation causing investors to sell their stock in that corporation); *Gilbert v. Nixon*, 429 F.2d 348 (10th Cir. 1970) (misleading prospectus and map in connection with oil lease and failure to convey correct information as to depth of oil well hole); *SEC v. National Bankers Life Ins. Co.*, 324 F. Supp. 189 (N.D. Tex.), aff'd per curiam, 448 F.2d 652 (5th Cir. 1971) (failure of defendants to notify purchasers of securities that shares' ever-increasing prices were due to defendants' market manipulation).

22. See, e.g., *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970) (sale of control of corporation in the form of sale of stock at a premium over market value); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969) (majority stockholder using control over corporation to acquire 500,000 shares at vastly inadequate price shortly before public announcement of corporation's oil discovery); *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968) (corporate directors' sale of corporation's stock to themselves).

23. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), aff'g 353 F. Supp. 264 (S.D.N.Y. 1972) (underwriter divulging material inside information

fiduciaries.²⁴ Although a plaintiff may not always win his case on the merits,²⁵ the breadth of the rule's scope has given even unresolved rule 10b-5 lawsuits a potential settlement value.²⁶

In contrast, lawsuits brought under section 18(a) have been virtually nonexistent.²⁷ Although this is attributable in part to the difficulties of proving a section 18(a) suit,²⁸ the primary reason for this development is that under the expansive judicial interpretations of rule 10b-5, section 18(a) protection became unnecessary.²⁹ For example, in *Miller v. Bargain City, U.S.A., Inc.*,³⁰ the plaintiffs had purchased Bargain City stock relying on information contained in detailed financial reports and statements filed with the SEC which the plaintiffs subsequently claimed was inaccurate and misleading. The defendant argued that a section 10(b) action could not be brought by the plaintiffs because they had alleged misconduct specifically covered by section 18 of the Act. In response, the court stated:

[I]t is true that the specific conduct alleged in the complaint would appear to amount to the type of fraud which is covered by section 18. However, it is also true that the complaint alleges that defendants employed a "device, scheme, or artifice to defraud" and that they engaged in an "act, practice or course of business" which operated as a fraud or deceit. These allegations are certainly broad enough to permit evidence of conduct violative of Rule 10b-5.³¹

Similarly, in *Heit v. Weitzen*,³² the plaintiffs alleged that they had purchased the defendant corporation's convertible debentures in reliance on various statements made in filed documents that misrepresented the corporation's net assets and past and prospective income. The court held that the complaint stated a cause of action under rule 10b-5.³³ More importantly, it noted that if the plaintiffs could establish actual reliance on the corporation's annual 10-K report,³⁴ a document filed with the SEC, they would have a concurrent

to its customers); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973) (corporation's tipping of material inside information creating market unfairness even though no direct action was taken on information conveyed); *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969) (corporate officers' purchases of stock and recommendations to others for such purchases while in possession of material undisclosed information relating to corporation's discovery of ore).

24. See, e.g., *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (dealer's violations of 1934 Act aided and abetted by corporation's failure to report to SEC his fraudulent use of customers' funds); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965) (misrepresentation and nondisclosure of facts material to plaintiffs' purchase and sale of stock by partner in stock brokerage firm); *Glickman v. Schweickart & Co.*, 242 F. Supp. 670 (S.D.N.Y. 1965) (misrepresentations by broker that recommended means of financing for plaintiff's purchase of stock was usual and proper).

25. See 3 L. Loss, *supra* note 10, at 1792.

26. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742-43 (1975).

27. See A. Jacobs, *supra* note 10, § 3.02[h], at 1-105 to -106.

28. See notes 10-14 *supra* and accompanying text.

29. See A. Jacobs, *supra* note 10, § 3.02[h], at 1-106 & n.26.

30. 229 F. Supp. 33 (E.D. Pa. 1964).

31. *Id.* at 36-37; *accord*, *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967).

32. 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

33. *Id.* at 914.

34. The 10-K report is an annual report filed with the SEC providing year-end financial information. See note 99 *infra* and accompanying text.

section 18 claim for relief as well.³⁵

The expansive era of section 10(b) came to a halt, however, with a series of recent Supreme Court decisions that have substantially reduced the scope of rule 10b-5.³⁶ Although not directly concerned with section 18(a), the underlying rationale of these decisions would seem to reject the reasoning of *Miller* and *Heit*, and bar a rule 10b-5 action when the claim would be assertable under section 18(a).

In *Blue Chip Stamps v. Manor Drug Stores*,³⁷ suit was brought under section 10(b) and rule 10b-5 by a nonpurchasing offeree of Blue Chip Stamp Company securities. The plaintiff alleged that the prospectus containing the offer, an extremely pessimistic document in its appraisal of the offeror's status and future prospects, was materially misleading and designed to discourage the plaintiff and other offerees from buying the shares at a bargain price, thereby enabling the offeror to sell the securities to the general public at a higher price.³⁸ In holding the plaintiff to be barred from maintaining the suit, a majority of the Court emphatically reinforced the validity of *Birnbaum v. Newport Steel Corp.*,³⁹ a Second Circuit case which had established that only a person who had been defrauded in connection with his own purchase or sale of securities had standing to bring a private cause of action under section 10(b) and rule 10b-5.⁴⁰ The Court in *Blue Chip* noted that Congress had rejected a proposed amendment to section 10(b) to change its wording from "in connection with the purchase or sale of any security" to "in connection with the purchase or sale of, or any attempt to purchase or sell, any security."⁴¹ This rejection was regarded as evidence of a congressional intent to limit the benefits of section 10(b)'s implied private right of action to actual purchasers and sellers.⁴² The Court also reasoned that because the express remedy sections of the 1934 Act and the Securities Act of 1933 were expressly limited to purchasers and sellers of securities⁴³ and had been enacted contem-

35. 402 F.2d at 916. For other cases that have permitted plaintiffs to bring suit under both § 18(a) and rule 10b-5 for the same alleged violations, either by refusing to accept the exclusivity argument or by simply ignoring the problem, see note 9 *supra*.

36. The Court's restriction of § 10(b) is part of an overall trend to narrow the scope of the federal securities laws. See, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (narrowing the definition of "material" misrepresentations giving rise to actionable wrongs under the 1934 Act); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976) (liability of stockholders under § 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976), limited to those having 10% beneficial interest before and after short-swing transaction); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975) (class of private litigants who may obtain injunctive relief under § 13(d) of the 1934 Act, 15 U.S.C. § 78m(d) (1976), limited to those who can show "irreparable harm"); *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975) (no implied cause of action held to exist under the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-78lll (1976), in favor of customers to compel the Securities Investor Protection Corporation to act).

37. 421 U.S. 723 (1975).

38. *Blue Chip* had been required, pursuant to a consent decree, to offer new shares to retailers who had used its stamp service in the past before the shares could be offered to the general public. *Id.* at 725-26.

39. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

40. 421 U.S. at 754-55.

41. *Id.* at 732 (citing S. 2545, 85th Cong., 1st Sess., 103 Cong. Rec. 11636 (1957)).

42. *Id.* at 733.

43. Securities Act of 1933, § 11, 15 U.S.C. § 77k (1976) (civil liability for false registration

poraneously with section 10(b), Congress could not have intended to create a broader plaintiff class in an implied cause of action than it had created under those express liability provisions.⁴⁴ Finally, the Court expressed concern over the possible increase in "strike suits" that could result from a widely expanded class of plaintiffs under rule 10b-5.⁴⁵

Less than one year after *Blue Chip*, the Supreme Court decided *Ernst & Ernst v. Hochfelder*.⁴⁶ An investor who used the services of a brokerage firm sought damages from Ernst & Ernst, the brokerage firm's public accountant, in a civil action for negligence brought under section 10(b) and rule 10b-5. The plaintiff alleged that Ernst & Ernst had failed to discover a fraudulent securities scheme perpetrated by the president of the brokerage firm. The Supreme Court held that section 10(b) was limited to willful and knowing acts and did not include negligent misstatements or omissions.⁴⁷ The Court based its decision on three considerations. First, it reasoned that because section 10(b) used the words "manipulative or deceptive devices or contrivances," Congress clearly intended to proscribe knowing or intentional misconduct "designed to deceive or defraud investors."⁴⁸ Second, the Court concluded that the legislative history of section 10(b) revealed no indication of a congressional intent to proscribe conduct that did not involve scienter.⁴⁹ The third basis for the Court's conclusion was its belief that the interrelated scheme of the federal securities laws would be seriously disrupted if section 10(b) were interpreted to reach negligence. Because those provisions imposing liability for negligence were accompanied by certain procedural limitations which had no counterpart in section 10(b), the use of a negligence standard in section 10(b) actions would, in effect, nullify the procedural restrictions present in the other provisions.⁵⁰ The Court also noted that section 10(b) lacked any safeguards to deter actions that were brought solely for their

statements); § 12, 15 U.S.C. § 77l (1976) (civil liability arising in connection with prospectuses and communications). Securities Exchange Act of 1934, § 9, 15 U.S.C. § 78i (1976) (civil liability for manipulation of security prices); § 18, 15 U.S.C. § 78r (1976) (civil liability for false or misleading statements in documents filed with the SEC).

44. 421 U.S. at 736.

45. *Id.* at 740-43, 749.

46. 425 U.S. 185 (1976).

47. *Id.* at 214. In so doing, the Supreme Court reversed the Seventh Circuit, which had held that one who breached a duty of inquiry and disclosure owed to another was liable in damages for aiding and abetting a third party's violation of rule 10b-5, if the fraud would have been discovered or prevented but for the breach. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974).

48. 425 U.S. at 199.

49. *Id.* at 202. The Court noted that § 10(b) had been described as a "catchall" clause designed "to enable the Commission 'to deal with new manipulative [or cunning] devices,' " and that it was difficult to believe that a legislative draftsman would have used these words if the intent had been to create liability for merely negligent acts or omissions. *Id.* at 203 (quoting *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934), reprinted in 8 Legislative History, *supra* note 15, Item 23, at 115 (1973)).

50. "Such extension [of § 10(b) to proscribe negligent conduct] would allow causes of action covered by §§ 11, 12(2), and 15 [the provisions prescribing liability for negligence] 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. *See generally id.* at 206-11.

potential settlement value, safeguards that were present in the express liability provisions.⁵¹

This restrictive interpretative approach has continued in more recent cases. In *Piper v. Chris-Craft Industries, Inc.*,⁵² the Supreme Court refused to imply a private damage remedy under section 10(b) in favor of a tender offeror claiming misrepresentation by a successful competitor.⁵³ The Court was guided by the principle that a private cause of action under the antifraud provisions of the Securities Exchange Act should not be implied when “unnecessary to ensure the fulfillment of Congress’ purposes”⁵⁴ in adopting the Act—the protection of the public investor.⁵⁵ Similarly, in *Santa Fe Industries, Inc. v. Green*,⁵⁶ the Court refused to imply a cause of action under rule 10b-5 for a breach of corporate fiduciary duty not involving manipulation or deception.⁵⁷ The Court’s reasoning was similar to that in *Hochfelder* and *Blue Chip*, namely that since both the language of section 10(b) and its legislative history indicate a concern with contrivances that defraud, it should not be extended into the complicated and completely different area of what constitutes proper corporate behavior.⁵⁸

As important as the particular holdings of these cases are, the common analytical framework throughout these decisions is even more significant. The

51. *Id.* at 210 & n.30. The Court also rejected the plaintiff’s contention that Ernst & Ernst had violated rule 10b-5. Although conceding that the language of rule 10b-5, viewed in isolation, could be read as proscribing any course of misconduct, “intentional or not,” the Court reasoned that because rule 10b-5 was promulgated in furtherance of § 10(b), it would be inappropriate for the rule’s scope to exceed the power Congress had granted the Commission under § 10(b). *Id.* at 212-14.

52. 430 U.S. 1 (1977).

53. *Id.* at 24-42. Both Chris-Craft Industries and Bangor Punta Corporation wished to acquire Piper, a corporation principally owned and managed by the Piper family. The family decided to block Chris-Craft’s takeover bid by negotiating with Bangor Punta for a merger. The family informed all shareholders that the price offered by Chris-Craft was inadequate, even though outside financial advisors had determined that the price was reasonable. Bangor agreed to pay the Pipers a premium for their shares, a fact which was not disclosed. Bangor also failed to reveal that one of its assets was overvalued by some \$13 million. Bangor then filed a registration statement and, while awaiting SEC approval, it purchased shares of Piper stock, obtaining control over the company. Chris-Craft then sued for an injunction against the merger, an order restraining Bangor from voting its shares, and for damages under § 10(b). *Id.* at 4-10.

54. *Id.* at 41.

55. The Court reasoned that the plaintiff here was actually seeking damages for having been wrongfully denied a “fair opportunity” to compete for control of another corporation, a situation that Congress should perhaps remedy, but one obviously not meant to be covered by existing federal securities legislation. *Id.* at 40-41.

56. 430 U.S. 462 (1977).

57. *Id.* at 474-77. In 1936, petitioner Santa Fe Industries had acquired control of 60% of the stock of Kirby Lumber Corporation, a Delaware corporation. Through a series of purchases over the following years, Santa Fe increased its control of Kirby’s stock to 95%. In 1974, wishing to acquire 100% ownership of Kirby, Santa Fe availed itself of § 253 of the Delaware Corporation Law, Del. Code Ann. tit. 8, § 253 (1975 & Cum. Supp. 1977), the state’s “short-form merger” statute which authorized the merger of a 90% owned subsidiary into the parent corporation by the unilateral vote of the parent’s board of directors. The provisions of this statute were fully complied with, but the minority stockholders of Kirby objected to the terms of the merger and brought this action. *Id.* at 465-67.

58. *Id.* at 477-78.

guiding principles that can be gleaned include: (1) an adherence to congressional intent, as evidenced by the statutory language and legislative history of section 10(b), and a desire to use section 10(b) only for the purposes for which it was drafted;⁵⁹ (2) a desire to construe section 10(b) consistently with other sections of the 1934 Act;⁶⁰ and (3) concern that the continued expansion of section 10(b) would result in an increase in strike suits or nuisance litigation brought for its settlement value.⁶¹

Despite these principles established by the Supreme Court, recent lower court decisions that have dealt with section 10(b) actions alleging violations within the scope of section 18(a) have been inconsistent in their pronouncements. In *Seiden v. Nicholson*,⁶² the plaintiffs brought suit under section 10(b) and rule 10b-5, alleging that the defendants had filed misleading annual and interim reports which artificially inflated the market price of the defendant corporation's stock, thereby causing the plaintiffs to purchase these securities at an excessive price. The defendants argued that rule 10b-5 should not be expanded so as to ignore the procedural requirements set out in the express liability sections of the securities laws and, therefore, if any cause of action did exist, it would have to be brought under section 18. The court, however, endorsed the view that securities legislation should be construed flexibly and that the remedies provided by the 1934 Act were cumulative.⁶³ Similarly, in *Gross v. Diversified Mortgage Investors*,⁶⁴ the plaintiffs alleged that they had purchased the defendant's shares in reliance on its "false and misleading annual and quarterly reports, financial statements and other materials"⁶⁵ filed with the SEC, claiming that this misconduct violated both section 18 and rule 10b-5. Although the court dismissed the plaintiffs' section 18 claim for failing to allege reliance on any particular document, it had no difficulty in finding that the action could still proceed solely on the claimed rule 10b-5 violation.⁶⁶

The court in *Kulchok v. Government Employees Insurance Co.*,⁶⁷ however, when presented with a plaintiff's claim of section 10(b) and section 18 violations for defendant's false and misleading statements in filed documents, held that no cause of action arose by implication under section 10(b) or rule 10b-5 based on violations encompassed by section 18:

[S]ince each misstatement or omission alleged . . . is a misstatement or omission which appears in a document filed by [the defendant] with the Securities and Exchange Commission . . . and since Section 18 of the Securities Exchange Act of 1934 provides an express civil private cause of action for damages with respect to documents filed with the SEC, the facts alleged . . . do not give rise to an implied cause of action under Section 10(b) . . . or SEC rules thereunder . . .⁶⁸

59. *Id.* at 472-74; *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. at 24-36; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 200-01; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 732-33.

60. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. at 42-46; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 206-11; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 734-36.

61. *Ernst & Ernst v. Hochfelder*, 425 U.S. at 208; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 739.

62. 69 F.R.D. 681 (N.D. Ill. 1976).

63. *Id.* at 684-86.

64. 431 F. Supp. 1080 (S.D.N.Y. 1977).

65. *Id.* at 1087.

66. *Id.* at 1093.

67. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,002 (D.D.C. 1977).

68. *Id.* at 91,512.

Although the Supreme Court cases discussed above were not directly concerned with section 18(a), the interpretative approach utilized by the Court would seem to undermine the viability of those cases that have rejected the exclusive application of section 18(a). Those cases do not sufficiently take into account the legislative histories of section 18(a) and section 10(b), a thorough examination of which would seem to be mandated by the recent Supreme Court decisions.⁶⁹ Such an examination clearly supports the exclusivity argument: when the facts alleged in a complaint fall within the purview of section 18(a), there should be no implied cause of action under section 10(b) and rule 10b-5.

B. *The Proper Relationship Between Section 18(a) And Section 10(b)*

In the debates concerning the passage of the 1934 Act, Congress clearly recognized the need for express civil remedies for violations of certain provisions of the Act:

[I]f an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party. . . . [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, or who makes a false or misleading statement in the report of a corporation, 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 or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in good faith.⁷⁰

The implementation of these purposes was left to three separate provisions. Section 9 proscribes the use of certain manipulative devices which affect the price of a security and the use of false or misleading statements to induce transactions in a security.⁷¹ Section 16(b) is designed to disgorge short-swing profits made by a director, officer, or 10% beneficial equity security holder,⁷² and section 18 is the express remedy provision for false or misleading statements in reports filed with the SEC which induce the purchase or sale of a security.⁷³

Section 18 contains carefully prescribed substantive and procedural requirements, indicating a congressional desire to tailor the remedy to the particular abuse it was designed to prevent. Under section 18, the class of plaintiffs is limited to those persons who, because of actual reliance on the false or misleading statements, purchased or sold a security whose price was affected by the statements.⁷⁴ The section expressly provides the issuer of the statement with a defense if he acted in good faith and had no knowledge that the statement was false or misleading.⁷⁵ Actions under section 18 are also limited by a relatively short statute of limitations,⁷⁶ and the district court in which the action is

69. See note 59 *supra* and accompanying text.

70. S. Rep. No. 792, 73d Cong., 2d Sess. 12-13 (1934), reprinted in 5 Legislative History, *supra* note 15, Item 17, at 12-13 (1973).

71. 15 U.S.C. § 78i (1976).

72. *Id.* § 78p(b) (1976). Short-swing profits are those profits realized by an officer, director, or beneficial owner of more than 10% of a corporation's equity securities in connection with the purchase and sale, within six months of one another, of equity securities in that corporation. *Id.*

73. *Id.* § 78r(a) (1976), quoted at note 6 *supra*.

74. *Id.*

75. *Id.*

76. *Id.* § 78r(c) (1976). This section provides: "No action shall be maintained to enforce any

brought is authorized to require the plaintiff to post a bond for costs, including attorney's fees, and to assess those costs at the conclusion of the litigation.⁷⁷

These carefully prescribed requirements of section 18 are not present in section 10(b) and rule 10b-5, though there are some similarities between the two causes of action. In actions brought under section 10(b) and rule 10b-5, the plaintiff must also be a purchaser or seller of a security,⁷⁸ and he must prove scienter on the part of the defendant in order to succeed.⁷⁹ Aside from a shift in the burden of proof, this scienter requirement is similar to the good faith defense provided defendants in section 18 actions.⁸⁰ These similarities, however, can not hide the fact that section 10(b) and rule 10b-5 do not have section 18's procedural restrictions relating to a statute of limitations, attorney's fees, and costs.⁸¹ By implying a cause of action under section 10(b) and rule 10b-5 for misconduct specifically covered by section 18, the courts have permitted plaintiffs to avoid section 18's limitations. Although a laissez-faire attitude toward securities fraud would not serve the purposes of the 1934 Act, there is still no general legal principle that courts, in fashioning substantive law, should do so in a manner that makes it easier for a plaintiff to obtain a judgment.⁸² Congress drafted section 18 and the civil liability sections with great care. By allowing section 10(b) and rule 10b-5 to cover violations that fall within the purview of section 18, the courts have, in effect, deemed it to be the intent of Congress to nullify the substantive and procedural restrictions of one section by implication in another. This interpretation is surely questionable. As the Supreme Court stated in *Hochfelder* in a similar context, "[w]e would be unwilling to bring about this result absent substantial support in the legislative history, and there is none."⁸³

The legislative history and purpose of section 10(b) also support the argument for the exclusivity of section 18(a). Section 10(b) was designed to close any loopholes which might develop in the SEC's ability to regulate speculative practices. In testimony during congressional hearings concerning the 1934 Act, one of the drafters of the Act explained that section 10(b) (then section 9(c)) was a catch-all clause designed to prevent the use of those manipulative devices not

liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued."

77. *Id.* § 78r(a) (1976), quoted at note 6 *supra*.

78. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975).

79. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976).

80. 3 L. Loss, *supra* note 10, at 1752.

81. Compare 15 U.S.C. § 78j(b) (1976) and 17 C.F.R. § 240.10b-5 (1977) with 15 U.S.C. §§ 78r(a), (c) (1976). Section 10(b) and rule 10b-5 contain no provisions relating to a statute of limitations or to the apportionment of attorneys' fees and costs.

82. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 742 (1975). The standard of proof for implied causes of action under § 10(b) and rule 10b-5 is also less burdensome to plaintiffs. Whereas constructive reliance is sufficient under § 10(b) and rule 10b-5, actual reliance must be proved by a § 18(a) plaintiff. See notes 102-03 *infra* and accompanying text.

83. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 (1976) (footnote omitted). In *Hochfelder*, the Supreme Court faced the analogous problem of whether to expand § 10(b) and rule 10b-5 to cover negligent misconduct, thereby allowing plaintiffs to bypass the procedural and substantive restrictions present in the provisions of the Securities Act of 1933 which expressly proscribe such misconduct.

already covered by express provisions.⁸⁴ The report of the Senate Committee on Banking and Currency similarly explained that section 10(b) "authorizes the Commission by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interests of the investor."⁸⁵ Thus, it is evident that section 10(b) was originally intended to be limited to use in connection with manipulative devices which were new and unknown in 1934,⁸⁶ activities far different from those towards which section 18 was directed.⁸⁷

The cases allowing section 10(b) and rule 10b-5 to overlap into the areas covered by section 18(a) also show no appreciation for the fact that section 10(b) is only one part, albeit an important one, in the entire scheme of federal securities regulation. The development of a sensible interrelationship between section 10(b) and section 18(a) is a necessary step for the smooth functioning of

84. *Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran), reprinted in 8 Legislative History, *supra* note 15, Item 23, at 115 (1973).

85. S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934), reprinted in 5 Legislative History, *supra* note 15, Item 17, at 18 (1973).

86. This was the situation in the seminal decision of *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), in which the court first implied a private cause of action under § 10(b) and rule 10b-5 because the defendant's activities did not fall within any of the express liability provisions of the federal securities laws. *Id.* at 514.

The administrative history of rule 10b-5 also gives no indication of the extremely expansive area which it has come to cover. In contrast to the carefully constructed express liability provisions of the 1934 Act, the rule had a surprisingly casual origin. As described by one of its drafters: "I looked at Section 10(b) and I looked at Section 17 [of the 1933 Act], and I put them together. . . . We called the Commission and we got on the calendar. . . . We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said 'Well . . . we are against fraud, aren't we?' That is how it happened." *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967) (statement of Milton Freeman). As Professor Loss argues, the courts should not continue to "go on building a tremendous jurisprudential superstructure on a little rule, 10b-5, that was adopted one afternoon in five minutes, at a time when the Commission was never thinking of civil liabilities." Loss, *The Opinion*, 24 Bus. Law. 527, 535 (1969).

87. Of course, any analysis of legislative history can become a two-edged sword. For example, § 17 of the Securities Act of 1933, 15 U.S.C. § 77q (1976), which makes it unlawful for any person to use a device, scheme, or untrue statement which operates as a fraud or deceit upon the purchaser of a security, has similarly been held to provide an implied private right of action, *see, e.g.*, *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975), though this infringes upon three express private remedies of the 1933 Act which appear to cover the great majority of abuses at which the Act's proscriptions were directed. *See* § 11, 15 U.S.C. § 77k (1976) (civil liability for false registration statements); § 12(1), (2), 15 U.S.C. § 77l(1), (2) (1976) (civil liability for false or misleading prospectuses and communications). This could be strong support for allowing the similar development of § 10(b) and rule 10b-5 in the 1934 Act. Any force to this argument is dissipated, however, when one realizes that the courts that have held a private right of action to exist under § 17 apparently proceeded on the supposition that "[o]nce it has been established . . . that an aggrieved buyer has a private action under § 10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under § 17 . . ." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). *See also Note, Section 17(a) of the 1933 Securities Act: An Alternative to the Recently Restricted Rule 10b-5*, 9 Rut.-Cam. L.J. 340, 348-50 (1977). Section 17's implied private remedy developed after and because of the expansion of § 10(b) and rule 10b-5, not vice versa.

the disclosure mechanisms instituted by the 1934 Act. This development is subverted, however, when plaintiffs are allowed to bring implied actions under section 10(b) and thereby avoid the substantive and procedural restrictions of section 18. Such a result disregards Congress' recognition of the significance of section 18's restrictions in protecting against strike suits,⁸⁸ and is in opposition to the Supreme Court's desire to establish the proper interaction between the provisions of the 1934 Act.⁸⁹

Cases involving the interaction of section 18 with other sections of the 1934 Act besides section 10(b) have exhibited a new-found receptivity to the exclusivity argument. For example, in *Lewis v. Elam*,⁹⁰ the court refused to imply a cause of action under section 13(a) of the 1934 Act⁹¹ for misconduct governed by the express sanctions found in section 18(a).⁹² In so holding, the court joined

88. The Senate Report specifically notes that the provision respecting assessment of costs was designed as a "[p]rotection against strike suits." S. Rep. No. 792, 73d Cong., 2d Sess. 21 (1934), reprinted in 5 Legislative History, *supra* note 15, Item 17, at 21 (1973).

89. See note 60 *supra* and accompanying text. A clear separation between the functions of § 10(b), rule 10b-5, and § 18(a) would also seem to be mandated by the maxim of statutory construction *expressio unius est exclusio alterius* (expression of one thing is the exclusion of another). The maxim was relied on in *National Railroad Passenger Corp. v. National Ass'n of Railroad Passengers*, 414 U.S. 453 (1974), in which the plaintiff sought an injunction to prevent the termination of rail service, basing his claim on an implied cause of action under the Rail Passengers Service Act of 1970, 45 U.S.C. §§ 501-645 (1976). The Act specifically empowered the Attorney General to enforce its provisions and contained no express authorization for suits by passengers in these circumstances. The Supreme Court refused to imply such a cause of action, declaring that because the Act created a public cause of action for its enforcement and a private cause of action only under very limited circumstances, the maxim compelled the conclusion that the remedies created expressly by the Act were the exclusive means by which to enforce its duties and obligations. 414 U.S. at 458. The analogy to the securities field is clear. The 1934 Act empowers the SEC to enforce its provisions, 15 U.S.C. § 78d (1976), and private causes of action are carefully and narrowly circumscribed. See notes 71-81 *supra* and accompanying text. Thus, § 18(a), and not § 10(b), should be invoked in actions by purchasers and sellers of securities injured by reliance on information filed with the SEC. Although the maxim "must yield to clear contrary evidence of legislative intent," 414 U.S. at 458, no such contrary evidence of legislative intent is indicated by the history behind either § 10(b) or § 18(a). See notes 74-86 *supra* and accompanying text.

Some commentators have criticized the use of the *expressio unius* maxim in *National Railroad*. See, e.g., McMahon & Rodos, *Judicial Implication of Private Causes of Action: Reappraisal and Retrenchment*, 80 Dick. L. Rev. 167, 184 (1976); Comment, *Private Rights of Action Under Amtrak and Ash: Some Implications for Implication*, 123 U. Pa. L. Rev. 1392, 1417 (1975); Note, *The Phenomenon of Implied Private Actions Under Federal Statutes: Judicial Insight, Legislative Oversight or Legislation by the Judiciary?*, 43 Fordham L. Rev. 441, 445, 457 (1974). This did not, however, prevent Judge Mulligan from utilizing the maxim in *Redington v. Touche Ross & Co.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,404 (2d Cir. Apr. 21, 1978), to argue that no implied private right of action should exist under § 17 of the 1934 Act, 15 U.S.C. § 78q (1976), for an alleged violation that comes within the coverage of § 18. [Current] Fed. Sec. L. Rep. (CCH) at 93,440 (Mulligan, J., dissenting).

90. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,013 (S.D.N.Y. 1977).

91. 15 U.S.C. § 78m(a) (1976). Section 13(a) requires every issuer of a security registered pursuant to § 12 of the Act, 15 U.S.C. § 78l (1976), to file with the SEC all information, documents, and reports as required by its rules and regulations for the proper protection of investors and to ensure fair dealing in the security.

92. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,554.

an increasing number of courts that have recognized the exclusivity of the express remedy found in section 18(a) in refusing to imply causes of action under section 13(a).⁹³

For section 18(a) to achieve full-fledged viability, it should not be bypassed simply because a plaintiff may find it more difficult to sustain his burden of proof under this section than under section 10(b).⁹⁴ Rather, any perceived deficiencies in the ability of section 18(a) to protect fully the public investor should be cured by a more logical interpretation of the section itself.

II. REVITALIZING SECTION 18

A. *The Current Status of Section 18*

The target of any reinterpretation of section 18(a) must be its two distinct, yet interrelated, requirements: (1) the false or misleading statement must be in a document filed with the SEC,⁹⁵ and (2) the plaintiff must have actually relied on the statement.⁹⁶

A wide variety of documents are filed with the SEC under the 1934 Act, the most important being the reports required under sections 13(a) and 15(d). Section 13(a) requires every issuer of a security registered pursuant to the Act to file such current reports as may be required by the SEC.⁹⁷ Section 15(d) of the Act requires issuers filing registration statements under the 1933 Act to file reports similar to those filed under section 13(a) in each year after the registration statement becomes effective, unless the class of securities sold is then held of record by fewer than 300 people.⁹⁸ The section 13(a) and 15(d) reports for most companies presently consist of an annual Form 10-K report providing year-end financial information, a Form 10-Q submitted after the end of each of the first three fiscal quarters supplying quarterly financial data, and a Form 8-K, the reporting form for significant current corporate events and transactions.⁹⁹

93. See, e.g., *Levy v. Johnson*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,899 (S.D.N.Y. 1977); *Myers v. American Leisure Time Enterprises, Inc.*, 402 F. Supp. 213 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 312 (2d Cir. 1976); *duPont v. Wyly*, 61 F.R.D. 615 (D. Del. 1973). *But cf. Redington v. Touche Ross & Co.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,404 (2d Cir. Apr. 21, 1978) (implied private right of action held to exist under § 17 of the 1934 Act for alleged violation within the coverage of § 18(a)). In *Redington*, the plaintiffs were brokers' customers injured as a result of an accountant's misleading statements. There had been, however, no purchase or sale of an affected security, *id.* at 93,435, and therefore implying a right of action in this case prevented the plaintiffs from being left without any remedy whatsoever.

94. See notes 102-03 *infra* and accompanying text.

95. 15 U.S.C. § 78r(a) (1976), *quoted at note 6 supra*.

96. Although actual reliance is not specified in the statute as a prerequisite for a plaintiff's claim, courts have interpreted § 18(a) to require actual reliance. See note 103 *infra* and accompanying text.

97. 15 U.S.C. § 78m(a) (1976). This section applies to issuers who are required to register a class of their securities under § 12 of the Act, *id.* § 78l (1976). Issuers are required to register under § 12 if a class of their securities is either listed on a national securities exchange or comprised of equity securities held of record by at least 500 persons and the issuer's total assets exceed \$1 million. *Id.* § 78l(b), (g) (1976).

98. 15 U.S.C. § 78o(d) (1976), *as amended by Act of Dec. 19, 1977, Pub. L. 95-213, § 204, 91 Stat. 1500.*

99. A. Jacobs, *supra* note 10, § 3.02[h], at 1-103. Form 10-K is required by 17 C.F.R. §§

Unfortunately, the great majority of these disclosures merely amount to public filings with the SEC without any physical delivery to individual investors.¹⁰⁰ Thus, any usefulness they might have is dependent on the extent to which public investors and members of the financial community actively seek out and use the filed information.¹⁰¹

Problems have also surrounded the actual reliance requirement of section 18. Whereas constructive reliance is the appropriate standard for implied causes of action brought under section 10(b) and rule 10b-5,¹⁰² "[r]eliance on the actual . . . report is an essential prerequisite for a Section 18 action and constructive reliance is not sufficient."¹⁰³ Therefore, a section 18(a) plaintiff is left with the virtually impossible task of proving actual reliance on filed documents that generally go unread. It therefore becomes evident that what is needed is a filed document that satisfies the investor's right to know and, at the same time, is more readily accessible to the public.

B. A Proposed Solution

Some commentators have attempted to resolve this predicament by arguing for a more flexible reliance requirement in section 18(a) actions.¹⁰⁴ An alternative solution to easing the plaintiff's burden under section 18(a) would be to classify the annual report received by the stockholders¹⁰⁵ as a "filed" document. This annual report is probably the most widely disseminated and used corporate disclosure document.¹⁰⁶ There are two basic reasons for its widespread use. First, annual reports include important substantive material:¹⁰⁷ (a) certified financial statements for the company's last two fiscal years;¹⁰⁸ (b) a summary of the company's recent operations and management's analysis of that material;¹⁰⁹ (c) a brief description of the company's business;¹¹⁰ (d) a "lines of business" breakdown for the company's operations;¹¹¹ (e) identification of the

240.13a-1, .15d-1 (1977). Form 10-Q is required by 17 C.F.R. §§ 240.13a-13, .15d-13 (1977). Form 8-K is required by 17 C.F.R. §§ 240.13a-11, .15d-11 (1977).

100. Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340, 1359 (1966).

101. *Id.* at 1360.

102. The Supreme Court resolved any doubt concerning the applicability of a constructive reliance standard in rule 10b-5 cases in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-54 (1972). *Accord*, *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978). *See also* *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

103. *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968) (footnote omitted), *cert. denied*, 395 U.S. 903 (1969). *See also* *Barotz v. Monarch Gen., Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,933, at 97,237 (S.D.N.Y. 1975).

104. *See, e.g.*, A. Jacobs, *supra* note 10, § 3.02[h], at 1-104 n.22; 3 L. Loss, *supra* note 10, at 1753 n.227.

105. The annual report is required to precede or accompany the proxy statement sent by management to the shareholders. 17 C.F.R. § 240.14a-3(b) (1977).

106. Sommer, *The Annual Report: A Prime Disclosure Document*, 1972 Duke L.J. 1093, 1098.

107. The disclosure of this material is not completely due to the corporation's concern with informing its shareholders. Rather, it is also required by the SEC. *See* notes 108-13 *infra* and accompanying text.

108. 17 C.F.R. §§ 240.14a-3(b)(1), (3) (1977).

109. *Id.* § 240.14a-3(b)(4).

110. *Id.* § 240.14a-3(b)(5).

111. *Id.* § 240.14a-3(b)(6). "Lines of business" refers to the various different business enterprises in which the corporation is engaged.

company's directors and executive officers;¹¹² and (f) identification of the principal market in which the company's voting securities are traded and a statement of the ranges of market price and dividends paid on such securities for each quarterly period during the company's two most recent fiscal years.¹¹³ Second, the annual report to the shareholders relays this information in a more discursive and interesting manner than the 10-K report¹¹⁴ which, though containing most of the above material,¹¹⁵ is less readable because of its formal nature.¹¹⁶ These attributes, combined with the fact that the stockholders' annual report is one of the few disclosure materials physically delivered to the public investor, enable it to be actually read, and thus relied on, by a greater number of people. By refusing to give "filed" status to the annual report,¹¹⁷ the SEC is preserving form at the expense of substance.

This proposal to include the annual report in the category of "filed" documents is not a new one. The SEC proposed an amendment in 1942 that would have expanded the definition of "proxy soliciting material" required to be filed with the SEC at least ten days before it is mailed to shareholders to include the annual report,¹¹⁸ thus subjecting the annual report to the potential liabilities of section 18(a).¹¹⁹ This proposal, however, resulted in a protest from issuers who complained that the effect of such liability would be to inhibit communication between management and shareholders concerning corporate affairs.¹²⁰ In response to these protests, the SEC finally decided not to enact the proposal,¹²¹ and the reports continued to be deemed not "filed" for purposes of section 18.¹²²

Although the SEC subsequently established indirect methods for regulating annual reports,¹²³ it has always retreated from classifying them as "filed" documents.¹²⁴ The courts, however, were unwilling to view this refusal to give

112. *Id.* § 240.14a-3(b)(7).

113. *Id.* § 240.14a-3(b)(8).

114. *Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 1st Sess. 20 (1943) (statement of then-SEC chairman Ganson Purcell) [hereinafter cited as 1943 Hearings].*

115. *See D. Beresford, R. Busch & R. Neary, SEC Form 10-K: A Guide to Financial Reporting* § 2.04 (1977).

116. *1943 Hearings, supra* note 114, at 20 (statement of then-SEC chairman Ganson Purcell).

117. The SEC has the power to require such a "filing." *See* 15 U.S.C. § 78w(a) (1976).

118. Sommer, *supra* note 106, at 1101-02.

119. *Id.* at 1102.

120. *Hearings on Stock Market Study Before the Senate Comm. on Banking and Currency, 84th Cong., 1st Sess. 1556 (1955), quoted in Sommer, supra* note 106, at 1102.

121. Sommer, *supra* note 106, at 1102.

122. This was explicitly confirmed in SEC Securities Exchange Act Release No. 3380 (Feb. 5, 1943).

123. In 1954, the SEC amended Form 10-K to require that if a registrant distributed an annual report to shareholders, a copy of the report must be furnished to the SEC not later than the date it was mailed to shareholders. If no such report was furnished to shareholders, the SEC should be so told in the form. SEC Release U-159 (Jan. 28, 1954). The report, however, is still not considered filed for § 18(a) purposes, and no liability is incurred under that section for false or misleading statements in the report. Instead, the SEC seems to indulge in the presumption that the prospect of examination of these furnished reports by interested public investors will be sufficient to maintain their accuracy. *See id.*

124. The closest the SEC ever came to so doing was subjecting the annual report to § 18

"filed" status to the stockholders' annual report as evidence that there should be no liability at all for false or misleading statements in these documents, and thus they applied section 10(b) and rule 10b-5 to fill the gap.¹²⁵ Although this use of section 10(b) and rule 10b-5 was understandable in that the courts were faced with a perceived wrong which had been left uncovered by any express remedy, the fact remains that this contributed to the expansion of both the section and the rule into areas not originally intended.

This improper use of section 10(b) and rule 10b-5 can be corrected by directly subjecting the annual report to the potential liabilities of section 18(a). Doing so would accomplish two goals: it would revitalize section 18(a) by making it applicable to an area which is well within its natural scope, and section 10(b) and rule 10b-5 would be replaced by a standard which provides the limitations on liability that Congress has deemed essential for similar securities reports and financial material.¹²⁶ This proposal is supported by Professor Loss who, as head of the American Law Institute's Federal Securities Code Project, said:

Another basic idea that might be developed is to give the Commission direct jurisdiction over the annual report to stockholders. That, after all, is the document that gets to people. . . . Why should we have a system in which the Commission regulates what goes into an occasional prospectus but cannot say what goes into the stockholders' report¹²⁷

Although the adoption of such a proposal may create the danger of making the annual report read like a 10-K report,¹²⁸ thirty-six years have passed since industry first protested the proposal for filing and potential liability under section 18(a).¹²⁹ During this interval, "[t]here has been a growth in the integrity of annual reports and in the convictions of corporate executives that the ultimate good of their corporations is best served by meaningful and accurate disclosure to the financial market place."¹³⁰ Since the annual report would thus not have to be dramatically altered if required for SEC filing purposes, there is little reason for management to fear such a proposal, especially if it were accompanied by rules preserving management's opportunity to speak to its shareholders in an informal fashion.¹³¹

Although the ultimate responsibility for implementing these suggestions lies

liability if it was incorporated by reference in other "filed" documents. 17 C.F.R. § 240.12b-23 (1977).

125. The trend was forecast in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), which held that the defendant's misleading press release was sufficient to satisfy the rule 10b-5 requirement that the misconduct be "in connection with the purchase or sale of any security." Subsequently, in *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969), rule 10b-5 was held to apply expressly to the annual report. Similarly, in *Dillon v. Berg*, 326 F. Supp. 1214, 1231 n.27 (D. Del.), *aff'd*, 453 F.2d 876 (3d Cir. 1971), the court recognized that false or misleading statements made in annual reports would give rise to liability under rule 10b-5.

126. See notes 74-77, 88 *supra* and accompanying text.

127. Loss, *The American Law Institute's Federal Securities Code Project*, 25 Bus. Law. 27, 33-34 (1969).

128. See notes 114-16 *supra* and accompanying text.

129. See notes 118-20 *supra* and accompanying text.

130. Sommer, *supra* note 106, at 1122.

131. *Id.*

with the SEC,¹³² the courts can play a key role in the process by following the Supreme Court's approach¹³³ and continuing to reduce the scope of section 10(b) and rule 10b-5 in areas that were meant to be covered by other sections. In this manner, section 18 will be seen as something more than just a superfluous provision, and the SEC may be encouraged to subject more material to its coverage.

CONCLUSION

An effort must be made to delineate carefully the respective roles of section 10(b), rule 10b-5, and section 18(a). The legislative history clearly emphasizes how Congress carefully tailored each provision of the Securities Exchange Act of 1934 to remedy a particular abuse. It is one thing for the courts to expand the protection of a provision to cover new problems not perceived by Congress in 1934. It is quite another for this judicially created remedy to engulf situations that were both foreseen and specifically provided for. Section 18(a) was not intended to become a toothless tiger. It became so because both the courts and the SEC enabled section 10(b) and rule 10b-5 to become all-encompassing. With the reordering suggested above, the 1934 Act should become a clearer and more integrated statute, and consequently be of greater use to today's securities investor.

John A. Occhipinti

132. See note 117 *supra*.

133. See notes 36-61 *supra* and accompanying text.