

Summer 1981

## Securities Regulation: Scierter Means Less Protective Power for the Securities and Exchange Commission

John Warshawsky

Follow this and additional works at: <https://scholarship.law.missouri.edu/mlr>



Part of the [Law Commons](#)

---

### Recommended Citation

John Warshawsky, *Securities Regulation: Scierter Means Less Protective Power for the Securities and Exchange Commission*, 46 MO. L. REV. (1981)

Available at: <https://scholarship.law.missouri.edu/mlr/vol46/iss3/8>

This Note is brought to you for free and open access by the Law Journals at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Missouri Law Review by an authorized editor of University of Missouri School of Law Scholarship Repository. For more information, please contact [bassettcw@missouri.edu](mailto:bassettcw@missouri.edu).

# SECURITIES REGULATION: "SCIENTER" MEANS LESS PROTECTIVE POWER FOR THE SECURITIES AND EXCHANGE COMMISSION

*Aaron v. Securities & Exchange Commission*<sup>1</sup>

On June 2, 1980, the United States Supreme Court handed down its decision in *Aaron v. SEC* and, in so doing, clarified what showings of "scienter"<sup>2</sup> are required when the Commission brings a civil action to enjoin violations of section 17(a) of the Securities Act of 1933,<sup>3</sup> section 10(b) of the Securities Exchange Act of 1934,<sup>4</sup> and rule 10b-5.<sup>5</sup>

The case arose as an SEC civil action against the petitioner, Peter E. Aaron, and seven others. Mr. Aaron was a managerial employee of E.L. Aaron & Co., a registered broker-dealer in New York City. Among Mr. Aaron's duties were supervising sales made by the firm's registered representatives and maintaining the "due diligence" files for securities in which the firm served as a "market maker."<sup>6</sup> One such security was the common

1. 446 U.S. 680 (1980).

2. "Scienter," as used in the *Aaron* decision, refers to a mental state embracing intent to deceive, manipulate, or defraud. The Court reserved judgment as to whether scienter may also include reckless behavior. *Id.* at 686 n.5.

3. 15 U.S.C. § 77q(a) (1976).

4. 15 U.S.C. § 78j(b) (1976).

5. 17 C.F.R. § 240.10b-5 (1980).

6. "Market maker" is defined in the Securities Exchange Act of 1934, § 3(a)(38), 15 U.S.C. § 78c(a)(38) (1976) as

any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.

A less technical definition appears in N. WOLFSON, R. PHILLIPS & T. RUSSO, *REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS* ¶ 3.03[1], at 3-9 n.28 (1977) ("A market maker is a firm which stands continuously ready to buy and sell securities for its own account from and to brokerage firms and retail customers. The readiness of such firms to make continuous markets is essential to the existence of a liquid stock market.").

"Due diligence files" contain information compiled by market makers through regular, unscheduled investigations of the corporation in whose securities they are making a market. Market makers are obligated to keep abreast of the corporation's affairs in order to avoid recommending unsound investments to their customers.

stock of Lawn-A-Mat Chemical & Equipment Corp. Despite the fact that Lawn-A-Mat's financial condition was deteriorating, two of E.L. Aaron's registered representatives solicited orders by making false and misleading statements to the effect that Lawn-A-Mat was in good financial condition, would be manufacturing a new tractor in the near future, and would be a sound investment likely to increase in value. Lawn-A-Mat officials learned about the misrepresentations and contacted the registered representatives and Mr. Aaron, requesting that the practices cease; nevertheless, the practices continued.<sup>7</sup>

In February 1976, the SEC filed a complaint seeking injunctive relief for alleged violations of section 17(a) of the Securities Act of 1933, section 10(b) of the Securities Exchange Act of 1934, and rule 10b-5 and, in May 1977, the United States District Court for the Southern District of New York granted a permanent injunction against Mr. Aaron.<sup>8</sup> Mr. Aaron appealed. The United States Court of Appeals for the Second Circuit affirmed, but noted that the Commission need only establish negligence to enjoin violations of section 17(a) of the 1933 Act or section 10(b) of the 1934 Act.<sup>9</sup> The Supreme Court, on writ of certiorari, vacated the court of appeals decision and held that the Commission must establish scienter to enjoin violations of sections 17(a)(1), 10(b), and rule 10b-5, but not to enjoin violations of sections 17(a)(2) and 17(a)(3).

Section 17(a) of the 1933 Act and section 10(b) of the 1934 Act are the two primary antifraud statutes in the field of securities regulation. Because both statutes contain general language, they have served as the basis for various forms of litigation in this field.

Section 10(b) proscribes the use of "any manipulative or deceptive device or contrivance" in connection with the "purchase or sale of any security . . . 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."<sup>10</sup> Under this statute, the Commission promulgated rule 10b-5 in 1942.<sup>11</sup> Rule 10b-5 is also broad, having adopted much of its language from section 17(a) of the 1933 Act. Unlike section 17(a),

7. Because Mr. Aaron maintained the due diligence files, he had additional information from which he could have determined that the statements made by the registered representatives were false and misleading.

8. SEC v. E.L. Aaron & Co., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043 (S.D.N.Y. May 5, 1977), *aff'd sub nom.* SEC v. Aaron, 605 F.2d 612 (2d Cir. 1979), *vacated*, 446 U.S. 680 (1980). The district court failed to address the scienter issue noting that "Peter Aaron's conduct under either a negligence or a scienter theory of liability violated and aided and abetted violations of the anti-fraud provisions of the securities laws." *Id.* at 91,685.

9. SEC v. Aaron, 605 F.2d 612, 623 (2d Cir. 1979), *vacated*, 446 U.S. 680 (1980).

10. 15 U.S.C. § 78j(b) (1976) (emphasis added).

11. 17 C.F.R. § 240.10b-5 (1980). The similarities between § 17(a) of the

which relates solely to sellers, section 10(b) and rule 10b-5 apply to both buyers and sellers of securities.

The broad application of section 10(b) and rule 10b-5 is furthered by the statute's failure to limit parties who may seek relief thereunder. Four years after rule 10b-5 was promulgated, the right of private parties to seek damages resulting from violations of section 10(b) and rule 10b-5 was recognized in *Kardon v. National Gypsum Co.*<sup>12</sup> Thus, after *Kardon*, section 10(b) and rule 10b-5 were available to private parties, in addition to their earlier-defined uses by the Commission in public enforcement actions. Only in recent years has the Supreme Court taken steps to limit their scope of protection.<sup>13</sup>

Until recently, the level of culpability required for a person to be found in violation of section 10(b) or rule 10b-5 was uncertain, particularly when the SEC was seeking injunctive relief. Prior to 1976, the Supreme Court had not ruled on the question of requisite culpability; accordingly, some circuits had adopted some form of a negligence standard,<sup>14</sup> while other circuits required greater culpability.<sup>15</sup> In 1976 the Court, in *Ernst & Ernst v. Hochfelder*,<sup>16</sup> held that scienter was required for a private party to recover damages under section 10(b) or rule 10b-5. Following the reasoning of *Hochfelder*, several circuits adopted a scienter standard for Commission

Securities Act of 1933 and rule 10b-5 are apparent when the language of the two are compared.

12. 69 F. Supp. 512 (E.D. Pa. 1946).

13. The most significant limitation appears in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). In this case, the Court held that one who is neither a purchaser nor a seller lacks standing to sue for damages under rule 10b-5. *Id.* at 755. By the time the Court so held, a number of circuits had already adopted such a rule of standing, first announced in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). An example of parties excluded by the *Blue Chip* holding are security holders who are victims of corporate mismanagement whose actions influenced security prices, but who failed to sell their holdings.

14. *See, e.g.*, *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 (2d Cir. 1972) (good faith no defense); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (negligence), *cert. denied*, 394 U.S. 976 (1969), *cert. denied*, 404 U.S. 1005 (1971); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963) (more than fraud covered by statute and rule); *Myzel v. Fields*, 386 F.2d 718, 734 (8th Cir. 1967) (knowledge of falseness not required), *cert. denied*, 390 U.S. 951 (1968); *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974) (flexible duty standard).

15. *See, e.g.*, *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (willful or reckless disregard for truth); *SEC v. Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974) (willful or reckless disregard for truth), *cert. denied*, 420 U.S. 908 (1975); *Clegg v. Conk*, 507 F.2d 1351, 1362 (10th Cir. 1974) (scienter or conscious fault), *cert. denied*, 422 U.S. 1007 (1975).

16. 425 U.S. 185 (1976).

enforcement actions.<sup>17</sup> The Second Circuit, however, reaffirmed its earlier position that, in an SEC enforcement action, the Commission need only establish negligence.<sup>18</sup> *Certiorari* was granted to reconcile the conflicting positions taken by the various circuits.<sup>19</sup>

In resolving the conflicting decisions regarding section 10(b) and rule 10b-5, the *Aaron* Court relied primarily on the *Hochfelder* decision.<sup>20</sup> *Hochfelder* involved a private action for damages brought by customers of a brokerage firm against the firm's independent auditors. The customers, having been swindled by the owner of the firm, charged the auditors with aiding and abetting the practices of the owner by *negligently* conducting audits which failed to expose his fraudulent activities. Thus, the Court was called on to determine whether an allegation of negligence would support a private action for damages under section 10(b) and rule 10b-5. The Court held that negligence was not sufficient to establish such liability, basing its decision on the language and legislative history of section 10(b) and the structure of the 1933 and 1934 Acts.<sup>21</sup>

While the *Hochfelder* decision reserved judgment on the scienter question with regard to Commission enforcement actions,<sup>22</sup> the *Aaron* decision is, to a large degree, guided by *Hochfelder*. The *Aaron* Court, reviewing the *Hochfelder* decision, noted that the "plain meaning" of the language in section 10(b) "clearly evinced a congressional intent to proscribe only 'knowing or intentional misconduct.'"<sup>23</sup> In support of this proposition,

17. See, e.g., *SEC v. Blatt*, 583 F.2d 1325, 1333 (5th Cir. 1978) (must show scienter); *SEC v. Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977) (must show recklessness). But see *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 14 (2d Cir. 1977) (district court read *Hochfelder* as applicable to SEC enforcement action, but court of appeals declined to abandon prior contrary holdings within the circuit).

18. 605 F.2d 612 (2d Cir. 1979), *vacated*, 446 U.S. 680 (1980). The court of appeals in *Aaron* was the same court which declined to apply *Hochfelder* to a Commission enforcement action two years earlier in *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977).

19. 444 U.S. 914 (1979).

20. 425 U.S. 185 (1976).

21. The Court relied on the "plain meaning" of the statute's language and the nonexistence of legislative history which contradicted the plain meaning interpretation. *Id.* at 197-206. The Court found further support in the interrelationship of the 1933 and 1934 Acts, noting that "[i]n each instance that Congress created express civil liability in favor of purchasers or sellers of securities it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake." *Id.* at 207. Finally, the Court noted that the negligence-based civil remedies under the Securities Act of 1933 were subject to "significant procedural restrictions not applicable under § 10(b)," such as requiring the posting of bond to cover costs and shortening the relevant statutes of limitations. *Id.* at 208-10.

22. *Id.* at 193 n.12.

23. 446 U.S. at 690.

the Court referred to statutory language such as "manipulative," "device," and "contrivance."<sup>24</sup> *Aaron* also reiterated the legislative history of section 10(b) as discussed in *Hochfelder*.<sup>25</sup> The Court concluded that the plain meaning of the statute as construed in *Hochfelder* applied to *any* alleged violation of section 10(b) or rule 10b-5, regardless of the nature of relief sought.<sup>26</sup>

In its determination, the Court rejected the Commission's contention that the case should have been decided under *SEC v. Capital Gains Research Bureau, Inc.*,<sup>27</sup> rather than *Hochfelder*. *Capital Gains* involved a Commission civil action for injunctive relief pursuant to section 206(2) of the Investment Advisers Act of 1940.<sup>28</sup> In *Capital Gains*, the Commission sought to compel investment advisers to disclose to clients those securities in which they had executed a personal transaction shortly before recommending them as investments to their clients.<sup>29</sup> The *Capital Gains* Court held that the Commission was not required to establish scienter to obtain injunctive relief under section 206(2) of the 1940 Act, basing their decision on the "philosophy of full disclosure" which pervades the securities laws enacted during the period of 1933 to 1940,<sup>30</sup> the fiduciary relationship which exists between an investment adviser and his client,<sup>31</sup> and the differences between a legal action for damages and an action for equitable relief.<sup>32</sup> The *Aaron* Court distinguished *Capital Gains* primarily on

24. *Id.*

25. *Id.* at 690-91.

26. *Id.* at 691.

27. 375 U.S. 180 (1963).

28. 15 U.S.C. § 80b-6(2) (1976).

29. The SEC wanted to eliminate the potential conflict of interest created when an investment adviser recommended securities which he personally held as an investment. By requiring disclosure of personal transactions recently executed in securities recommended, the Commission sought to decrease the incidence of "scalping," a practice where the investment adviser would buy a security, recommend it to his clients for long-term investment, and sell his holdings when the market price rose due to increased demand for the security.

30. 375 U.S. at 186.

31. *Id.* at 191-92.

32. *Id.* at 192-95. Of particular importance with regard to this point, the *Capital Gains* Court noted that "[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element." *Id.* at 193 (quoting DEFUNIAK, HANDBOOK OF MODERN EQUITY 235 (2d ed. 1956)). The Court further noted:

There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

*Id.* at 194 (footnote omitted). It was the contention of the Commission that this rationale made *Capital Gains* the guiding precedent for the *Aaron* decision.

legislative history and language, and the applicability of section 10(b) and rule 10b-5 to nonfiduciary settings.<sup>33</sup>

In answering the scienter questions regarding section 17(a), the *Aaron* Court utilized a "plain meaning" test to interpret the statute. Noting that there was little precedential authority to guide it,<sup>34</sup> the Court stated the test as follows: "[I]f the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary 'to examine the additional considerations of 'policy' . . . that may have influenced the lawmakers in their formulation of the statute.'"<sup>35</sup>

Applying this standard, the Court found section 17(a)(1) to require a showing of scienter. It stated that "[t]he language of § 17(a)(1), which makes it unlawful 'to employ any device, scheme, or artifice to defraud,' plainly evinces an intent on the part of Congress to proscribe only knowing or intentional misconduct."<sup>36</sup> The Court reasoned that "device," "scheme," and "artifice" could not be used to describe merely negligent activities.<sup>37</sup> On the other hand, it found no scienter requirement under sections 17(a)(2) or 17(a)(3) because the language of the two subsections failed to include any references to a mental state.<sup>38</sup>

33. 446 U.S. at 694-95. Justice Blackmun, in his dissenting opinion, maintained that *Capital Gains* was controlling precedent and that the Court's distinctions were unpersuasive. Blackmun believed that the differences between *Capital Gains* and *Aaron* existed because, in *Capital Gains*, an "omission to state material facts" was involved, while in *Aaron*, "actual dissemination of material false statements" had occurred. The fiduciary relationship was necessary in *Capital Gains* only because omissions to act were involved and a fiduciary relationship was necessary to create a duty of disclosure. *Id.* at 709-11 (Blackmun, J., dissenting in part).

34. The *Hochfelder* decision was unquestionably the most significant precedent available to the *Aaron* Court. Although *Hochfelder* established scienter requirements under § 10(b) and rule 10b-5, because of the similarities in language between § 17(a) and rule 10b-5, some courts applied *Hochfelder* to § 17(a) actions, as well. *Compare Sanders v. John Nuveen & Co.*, 554 F.2d 790, 795-96 (7th Cir. 1977) (scienter required under § 17(a)) *with* *SEC v. World Radio Mission, Inc.*, 544 F.2d 535, 540 (1st Cir. 1976) (state of mind irrelevant) *and* *SEC v. American Realty Trust*, 586 F.2d 1001, 1005-07 (4th Cir. 1978) (no scienter requirement under § 17(a)). Prior to the *Aaron* decision, the Supreme Court had not addressed the scienter question with regard to § 17(a).

35. 446 U.S. at 695 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. at 214 n.33).

36. *Id.* at 696.

37. *Id.*

38. With regard to § 17(a)(2), the Court stated that "the language of § 17(a)(2), which prohibits any person from obtaining money or property 'by means of any untrue statement of a material fact or any omission to state a material fact,' is devoid of any suggestion whatsoever of a scienter requirement." *Id.* Similarly, with regard to § 17(a)(3), the Court stated that "the language of §

In approving a nonuniform culpability standard for section 17(a), the Court reviewed the legislative history and concluded that, although the history of the statute was ambiguous, it may be read consistently with the plain meaning of the statute's language.<sup>39</sup> Thus, the Court adopted the plain meaning of the statutory language even though, in doing so, different levels of culpability were established within section 17(a).

Although the *Aaron* decision puts to rest the problem of conflicting decisions within the federal courts, the analysis used is incomplete. In particular, the Court failed to address the distinctions which may be drawn between a private suit for damages and a Commission action seeking injunctive relief. While there are strong policy considerations for requiring scienter before damages will be awarded, these considerations are not present in a Commission enforcement action.<sup>40</sup> This is the primary reason that the Court's strong reliance on *Hochfelder* as guiding precedent is troubling. The adherence to *Hochfelder* also disturbed Justice Blackmun who, joined by Justices Brennan and Marshall, dissented in part with reference to the Court's required findings of scienter under sections 17(a)(1), 10(b), and rule 10b-5.<sup>41</sup> While Justice Blackmun took issue with the Court's plain meaning interpretations of the law and its failure to distinguish between fraud at law and at equity, his most vehement disagreement was with the majority's "failure to appreciate the structural interrelationship among equitable remedies in the 1933 and 1934 Acts, and to accord that interrelationship proper weight in determining the substantive reach of the Commission's enforcement powers under § 17(a) and § 10(b)."<sup>42</sup> Justice Blackmun pointed to "the consistent pattern in both the 1933 Act and the 1934 Act . . . to grant the Commission broad authority to seek enforcement without regard to scienter, unless criminal punishments . . . [were] contemplated."<sup>43</sup> In addition, Justice Blackmun disagreed with what he termed the "halfway house" approach adopted by

---

17(a)(3), under which it is unlawful for any person 'to engage in any transaction, practice, or course of business which *operates* or *would operate* as a fraud or deceit,' . . . quite plainly focuses upon the *effect* of particular conduct on members of the investing public . . ." *Id.* at 696-97.

39. *Id.* at 699-700.

40. The *Hochfelder* Court wanted to prevent the securities laws from becoming a vehicle for reaching a financially sound, but less than culpable defendant (in common parlance, sometimes referred to as the "deep pocket"). Accordingly, the Court strictly construed § 10(b) and rule 10b-5 and determined that mere negligence was not sufficient for a private party to recover damages under the statute or the rule. While such considerations are relevant when the remedy sought is private damages, they are wholly irrelevant in a public enforcement action since damages are not at issue.

41. Justice Blackmun also wrote the dissenting opinion in *Hochfelder*.

42. 446 U.S. at 713 (Blackmun, J., dissenting in part).

43. *Id.* (Blackmun, J., dissenting in part).



the Court with regard to section 17(a) under which negligence is the appropriate standard for violations of sections 17(a)(2) and 17(a)(3), but not section 17(a)(1). While sections 17(a) and 10(b) were designed to operate in harmony, Justice Blackmun noted that the Court's decision provides for the anomalous result that, in certain instances of negligent misrepresentation, conduct by a seller may be enjoined, but similar conduct by a buyer may not be.<sup>44</sup>

A logical analysis of the opinion may be supportive of the decision. The Court's interpretation, however, has deficiencies when applied in practical situations. These problems become apparent if one inquires whether Congress intended the SEC *only* to be able to prevent losses wrought by deliberate acts to defraud, instead of empowering it with a flexible form of public protection which would allow the Commission to enjoin negligent behavior having similar potential to cause investor losses.<sup>45</sup> The practical implication of the narrow view adopted by the *Aaron* Court is that the Commission will be unable to protect the public against losses caused by a negligent party, except where such negligence can be characterized as a section 17(a)(2) or section 17(a)(3) violation. In the words of Justice Blackmun, "when misinformation causes loss, it is small comfort to the investor to know that he has been bilked by negligent mistake rather than by fraudulent design, particularly when recovery of his loss has been foreclosed by this Court's decisions."<sup>46</sup>

The Supreme Court's decision does resolve an area of dispute, but the resolution is based on strict construction of the relevant statutes, apparently with little consideration being accorded to the weakened protective powers that are left to the SEC. As a result of this technical reading by the Court, either greater dangers of loss will be transferred to the investing public or courts will be forced to conclude that scienter is present in situations which, prior to *Aaron*, might have been answered otherwise. While the Court's decision does not stand contrary to reasonable statutory construction, a decision establishing less restrictive standards for Commission enforcement actions also would have been possible without offending

---

44. *Id.* at 715 (Blackmun, J., dissenting in part). This seemingly paradoxical result is possible because the *Aaron* decision held negligence to be the appropriate standard only for violations of § 17(a)(2) and § 17(a)(3). Since § 17(a) only applies to sellers, equally culpable conduct on the part of a buyer will not be enjoined as scienter is required to find a violation of § 10(b) or rule 10b-5 (which apply to both buyers and sellers). The paradox is even more apparent when one recalls the similarity of the language in § 17(a) and rule 10b-5 and attempts to reconcile the Court's requirement of different levels of culpability.

45. This dilemma provided the basic difference between the courts which treated SEC enforcement actions in the same manner as private damages suits and the courts which perceived different standards between the two types of actions. See cases cited notes 14, 15, 17 & 18 and accompanying text *supra*.

46. 446 U.S. at 716 (Blackmun, J., dissenting in part).