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Scienter in SEC Injunctive Proceedings

SCIENTER IN SEC INJUNCTIVE PROCEEDINGS

In *Ernst & Ernst v. Hochfelder*,[1] the Supreme Court established "scienter"[2] as a necessary element of a private damage action under section 10(b) of the Securities Exchange Act of 1934 ('34 Act)[3] and rule 10b-5 promulgated thereunder.[4] The Court declined, however, to address specifically whether proof of scienter is required in injunctive actions by

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[1] 425 U.S. 185, 193 (1976).

[2] This note will use the term "scienter" to refer to a degree of culpability greater than negligence. The term scienter has eluded, however, a uniform definition in the securities litigation context. In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Supreme Court referred initially to scienter as proscribing conduct evinced by an intent to deceive, manipulate, or defraud. *Id.* at 193 n.12. In subsequent references to the phrase, however, the *Hochfelder* Court implied that the term scienter encompassed mental states ranging from intent, to knowledge of falsity, to recklessness. *See* Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5*: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213, 218-220 (1977). The prevailing view in the federal circuit courts is that reckless behavior constitutes scienter. *See, e.g.*, Broad v. Rockwell Int'l Corp., 614 F.2d 418, 440 (5th Cir. 1980); McLean v. Alexander, 599 F.2d 1190, 1197-98 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); Nelson v. Serwold, 576 F.2d 1332, 1336-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039-40 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

In Aaron v. SEC, 446 U.S. 680 (1980), the Supreme Court relied upon language in *Hochfelder* in defining the scienter term. *Aaron* contains conflicting language on the degree of culpability necessary to establish scienter. Initially, the Court referred to scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 686 n.5. In a subsequent reference, however, the *Aaron* Court noted that "knowing or intentional misconduct" sufficed as proof of scienter. *Id.* at 696. In addition, the Supreme Court reserved the question whether scienter embraces recklessness. *Id.* at 686 n.5.

[3] 15 U.S.C. § 78j(b) (1976). Section 10(b) of the Securities Exchange Act of 1934 ('34 Act) makes it

> unlawful for any person . . . (b) [t]o use or employ, in connection with the purchase or sale of any security . . . 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.

[4] 17 C.F.R. § 240.10b-5 (1980). Promulgated pursuant to the rulemaking authority of the SEC, rule 10b-5 provides

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

the Securities and Exchange Commission (SEC).[5] Federal courts considering this issue subsequent to *Hochfelder* have expressed conflicting views concerning the degree of culpability necessary to support an SEC action for injunctive relief.[6] The Supreme Court's decision in *Aaron v. SEC*[7] established clearly that the SEC must prove scienter in a civil enforcement proceeding to enjoin violations of section 17(a)(1) of the Securities Act of 1933 ('33 Act),[8] section 10(b) of the '34 Act, and Commission rule 10b-5.[9]

Aaron, the petitioner, was a managerial employee of E.L. Aaron & Company, an SEC registered broker-dealer.[10] His principal duties involved the supervision of E.L. Aaron's registered representatives and the maintenance of the firm's files for those securities in which the firm acted as a market maker.[11] While supervising the activities of the firm's registered representatives, Aaron learned that two representatives made false and misleading statements concerning Lawn-A-Mat Chemical and Equipment Corporation ("LAM"), a company in which E.L. Aaron was a market maker.[12] Since he was responsible for LAM's due diligence

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[5] *See* 425 U.S. at 193 n.12.

[6] *Compare* SEC v. Blatt, 583 F.2d 1325, 1332-33 (5th Cir. 1978) (SEC must prove scienter in injunctive action under § 10(b) of Securities Exchange Act of 1934 and rule 10b-5) *with* SEC v. Aaron, 605 F.2d 612, 623 (2d Cir. 1979), *vacated*, 446 U.S. 680 (1980) (scienter not element of SEC injunctive action under § 10(b) and rule 10b-5) *and* SEC v. World Radio Mission, Inc., 544 F.2d 535, 541 n.10 (1st Cir. 1976) (scienter not required in SEC injunctive actions under § 17(a) of Securities Act of 1933 ('33 Act)).

[7] 446 U.S. 680 (1980).

[8] 15 U.S.C. § 77q(a) (1976). Section 17(a) of the Securities Act of 1933 provides

> It shall be unlawful for any persons in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[9] 446 U.S. at 701-02.

[10] *See* SEC v. Aaron, 605 F.2d 612, 614 (2d Cir. 1979), *vacated on other grounds*, 446 U.S. 680 (1980). E.L. Aaron & Co. was Aaron's father's firm. Although Aaron worked as his father's assistant, he held no official corporate title. *Id.* He was not registered with the National Association of Securities Dealers as a principal of E.L. Aaron & Co. *Id.* Aaron asserted at trial that his lack of corporate title insulated him from liability for employees' actions. *Id.* at 617. The trial court and the Second Circuit held injunctive relief could issue against Aaron despite his lack of title, since he exercised supervisory control over the employees. *Id.*

[11] 446 U.S. at 682. *See generally* Bloomenthal, *Market-Makers, Manipulators and Shell Games*, 45 ST. JOHN'S L. REV. 597 (1971) (discussing role of market maker).

[12] 446 U.S. at 683. Aaron supervised the two registered representatives who operated E.L. Aaron & Co.'s Roslyn Heights, New York sales office. SEC v. Aaron, 605 F.2d 614, 615 (2d Cir. 1979). In soliciting orders for the common stock of Lawn-A-Mat Chemical & Equipment Corporation ("LAM"), the two registered representatives falsely informed prospective purchasers of LAM stock that LAM was producing new products and that the corporation

files, Aaron had reason to know of the false and misleading nature of the two representatives' statements.[13] Although the representatives were under his direct control and supervision, Aaron did not take affirmative action to prevent the representatives from continuing their deceptive practices.[14] The SEC commenced suit seeking preliminary and final injunctive relief under section 20(b) of the '33 Act[15] and section 21(d) of the '34 Act.[16] The Commission alleged specifically that Aaron had violated and aided and abetted violations of section 17(a), section 10(b), and rule 10b-5 by failing to take adequate steps to prevent the fraudulent practices of the registered representatives from continuing.[17]

A federal district court concluded that Aaron violated and aided and abetted violations of the three securities provisions and granted injunctive relief.[18] Although the district court noted that proof of negligence alone may have satisfied the culpability standard in a Commission civil enforcement proceeding, the district court found that Aaron's inten-

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was financially stable. 446 U.S. at 682-83. At the time these statements were made, LAM was losing money. *Id.* at 683. Several prospective investors complained to LAM officials about the representatives' statements. *Id.* An LAM officer warned the representatives to cease their deceptive acts. *Id.* An LAM attorney also contacted Aaron on two occasions and informed him that the registered representatives were making false and misleading statements. *Id.*

[13] 446 U.S. at 683. Representatives of a broker-dealer or underwriter hold a "due diligence" meeting shortly after registration statement becomes effective to question officials of the issuing corporation on corporate affairs disclosed in a registration statement. *See* 3A H. BLOOMENTHAL, SECURITIES & FEDERAL CORPORATE LAW 8.15(3)(a) (1980) [hereinafter cited as BLOOMENTHAL]. The broker-dealer or underwriter holds this meeting and keeps records of any meetings or conversations with the issuing corporation's officials for the purpose of establishing due diligence in the registration transaction. *Id.* Aaron had access to the LAM due diligence records and files. The reports in the LAM due diligence files indicated the deteriorating financial condition of LAM and revealed that LAM had no plans for new products. 446 U.S. at 683. Upon receiving information from LAM's attorney about the registered representatives' statements, Aaron had reason to know, therefore, that the statements were false and misleading. *Id.*

[14] 446 U.S. at 483. Aaron's only action upon learning of the misstatements was to request one of the representatives to speak with the LAM attorney concerning the matter. *Id.*

[15] 15 U.S.C. § 77t(b) (1976). Section 20(b) of the '33 Act permits the SEC to seek temporary or permanent injunction in federal district court to enjoin any person violating or about to violate the '33 Act or rules or regulations promulgated thereunder. *Id.*

[16] 15 U.S.C. § 78u(d) (1976). Section 21(d) of the '34 Act authorizes the SEC to seek an injunction against any person violating or about to violate the provisions of the '34 Act or rules or regulations promulgated thereunder. *Id.*

[17] 446 U.S. at 684. The SEC's complaint named seven defendants in addition to Aaron. These other seven defendants consented to injunctions before trail. *Id.*

[18] SEC v. Aaron, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043, at 91,687 (S.D.N.Y. 1977), *aff'd*, 605 F.2d 612 (2d Cir. 1979), *vacated*, 446 U.S. 680 (1980). The district court found that Aaron had intentionally failed to discharge his supervisory responsibility to stop the representatives from making statements that Aaron knew were false and misleading. The district court reasoned that injunctive relief was warranted in light of the nature of the violations, Aaron's failure to recognize the wrongful nature of his conduct, and the reasonable likelihood of future misconduct. 446 U.S. at 684-85.

tional failure to prevent the violations from continuing established scienter and eliminated the need to rely on a negligence standard.[19] On appeal, the Second Circuit affirmed the lower court's injunction.[20] The appellate court held, however, that the district court's finding of scienter was unnecessary because in a Commission enforcement proceeding proof of negligence sufficed to establish a defendant's violation of the federal securities laws.[21]

Subsequently, the Supreme Court granted certiorari in *Aaron* to resolve the federal court controversy concerning whether the SEC must establish scienter as an element in injunctive actions to enjoin violations of section 17(a) of the '33 Act, section 10(b) of the '34 Act, and rule 10b-5.[22] The SEC urged that differences between the nature of private damage actions and injunctive actions, the policy considerations underlying the securities laws demanded that courts apply a negligence standard in Commission injunctive actions.[23] In addition, the Commission argued that the language and legislative history of section 17(a), section 10(b), and rule 10b-5 supported application of a negligence standard in SEC enforcement proceedings.[24] The Supreme Court partially rejected the SEC's arguments, finding that the plain meaning of the statutory language and legislative history of section 17(a)(1), section 10(b), and rule 10b-5 manifested Congress' intent to prescribe a scienter requirement in all actions pursuant to the three provisions.[25] The Court held, however, that the Commission need not establish scienter as an element to enjoin violations of section 17(a)(2) and section 17(a)(3).[26] The *Aaron* Court vacated the Second Circuit's decision and remanded the case to the Second Circuit.[27]

The *Aaron* Court felt constrained by the Court's analysis in *Hochfelder* of section 10(b) and rule 10b-5, finding that scienter was an element of a private damage action.[28] The *Hochfelder* Court concluded

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[19] SEC v. Aaron, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,043, at 91,685 (S.D.N.Y. 1977); *see* 446 U.S. at 684.

[20] SEC v. Aaron, 605 F.2d 612, 619-24 (2d Cir. 1979).

[21] *Id.* at 619; *see* 446 U.S. at 685-86.

[22] *See* 446 U.S. at 686.

[23] *Id.* at 691-92. The Commission asserted that SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) should control the construction of § 10(b) in SEC civil enforcement proceedings. 446 U.S. at 691-92. In *Capital Gains*, the Supreme Court noted that the requisite elements of proof in a common law fraud action in equity were less severe than the elements of proof in actions at law. 375 U.S. at 192-94. The *Aaron* Court did not find *Capital Gains* determinative of the Commission's standard of proof in actions under § 10(b). 446 U.S. at 695; *see* text accompanying notes 34-41 and 80-110 *infra*.

[24] 446 U.S. at 694 n.11, 699. *See also* text accompanying notes 72-76 *infra*.

[25] 446 U.S. at 690-700; *see* text accompanying notes 72-76 *infra*.

[26] 446 U.S. at 697; *see* text accompanying notes 46-52 *infra*.

[27] 446 U.S. at 701-02.

[28] *Id.* at 689-90. *Hochfelder* involved a private action for damages against an accounting firm for securities laws violations. 425 U.S. at 188-89. The president of a brokerage firm induced plaintiffs to invest in a securities scheme. *Id.* The president converted the invested

that the terms "manipulative," "deceptive," "device," and "contrivance" used in section 10(b) suggested that Congress intended to prescribe a culpability standard for a section 10(b) violation based only on "knowing or intentional misconduct."[29] The *Hochfelder* Court found no contrary congressional intent in the history of the '34 Act.[30] The SEC's rulemaking authority consists only of the power to adopt regulations to carry into effect Congress' intent as expressed in the statutory provisions of the federal securities laws.[31] Accordingly, the standard of culpability of section 10(b) also must control the construction of rule 10b-5.[32] Reasoning that the language and legislative history of section 10(b) apply to both injunctive actions and private damage actions, the *Aaron* Court concluded that scienter is an element of section 10(b) and rule 10b-5 violations, regardless of the plaintiff's identity.[33]

The Supreme Court in *Aaron* also noted that *SEC v. Capital Gains Research Bureau, Inc.*[34] did not mandate the application of a negligence standard in Commission enforcement proceedings under section 10(b)

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funds to his own use. After the president committed suicide, plaintiff investors brought suit against the accounting firm retained to periodically audit the brokerage firm's books. *Id.* at 188-90. Plaintiffs charged the accounting firm with failing to conduct proper audits that would have discovered the fraudulent practices of the brokerage firm's president. *Id.* at 190. The plaintiffs alleged that the accounting firm violated § 10(b) and rule 10b-5. *Id.* As a defense, the accounting firm asserted that a cause of action could not lie under § 10(b) and rule 10b-5 on allegations of negligence. *Id.* at 191.

The *Hochfelder* Court focused on three factors to determine that a scienter requirement existed under § 10(b) and rule 10b-5. *Id.* at 197-212. Two of these factors, the statutory language and legislative history of § 10(b), are relevant to a determination of whether scienter is required in SEC injunctive actions. 446 U.S. at 691. The *Aaron* Court concluded that the third factor, the interrelationship of the antifraud provisions of the '33 and '34 Acts, was not relevant in enforcement proceedings. *Id.* at 691 n.9. *See also* Note, *1975-1976 Securities Law Developments: Rule 10b-5*, 33 WASH. & LEE L. REV. 937, 937-44 (1976).

[29] 425 U.S. at 197; *see* text accompanying notes 57-62 *infra*.

[30] 425 U.S. at 201-02. The *Hochfelder* Court conceded that the legislative history of the '34 Act "is bereft of any explicit explanation of Congress' intent." *Id.* at 201. The Court focused, however, on a statement by a spokesman for the original drafters describing § 9(c), the predecessor to § 10(b), as a "catch-all" provision to prevent "manipulative" and "cunning" devices. *Id.* at 202-03 quoting *Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess., 115 (1934). The *Hochfelder* Court also rejected the SEC's contention that the absence of an explicit willfulness requirement, which appears in § 9 of the '34 Act, 15 U.S.C. 78(i) (1976), demonstrated congressional intent to require only proof of negligence under § 10(b). 425 U.S. at 207-08. The Court noted that where Congress intended to recognize liability for negligent conduct, Congress used different language from that appearing in § 10(b). *Id.* at 208-10.

[31] 425 U.S. at 213-14; *see* 446 U.S. at 691; Dixon v. United States, 381 U.S. 68, 74 (1965).

[32] 425 U.S. at 214.

[33] 446 U.S. at 691. As further support for holding that the language and legislative history of § 10(b) apply to injunctive actions, the *Aaron* Court noted that at the time Congress enacted § 10(b), the legislature did not contemplate an implied private cause of action. *Id.*; *see* text accompanying notes 60-61 *infra*.

[34] 375 U.S. 180 (1963).

and rule 10b-5.[35] In *Capital Gains*, the Supreme Court found persuasive the legislative history of section 206(2) of the Investment Advisors Act of 1940 ('40 Act)[36] and SEC policy arguments that the Commission need not prove a defendant-investment adviser acted with scienter to enjoin his deceptive practices.[37] Analogizing an action under the antifraud provisions of the '40 Act with a common law fraud action, the *Capital Gains* Court held that the "mild prophylactic" effect of a Commission injunction made requiring proof of scienter in SEC enforcement proceedings unnecessary.[38] The *Aaron* Court distinguished *Capital Gains* because section 206(2) legislative history and statutory language indicated the absence of a scienter requirement.[39] Moreover, section 206(2) regulates a fiduciary relationship. Even under common law fraud principles, a plaintiff need not establish scienter in a damage suit against a fiduciary.[40] The *Aaron* Court refused to adopt the *Capital Gains* reasoning because section 10(b) applies to both fiduciary and nonfiduciary relationships and contains specific language indicating the existence of a scienter requirement.[41]

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[35] 446 U.S. at 691-95.

[36] 15 U.S.C. § 80b-6 (1976). Section 206(2) of the Investment Advisors Act of 1940 ('40 Act) provides

> It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

[37] 375 U.S. at 186-97. The defendants in *Capital Gains* were publishers of investment advisory services. On six different occasions, the defendants purchased securities in advance of recommending the same securities in their investment advisory publications. *Id.* at 182-83. In each instance the market price of the security increased after the recommendations appeared in the investment advisory services. *Id.* at 183. The defendants did not disclose their interests in the recommended securities to clients or prospective clients of the investment advisory services. *Id.* The SEC commenced suit seeking preliminary injunctive relief against the defendants' activities. *Id.* The Commission requested an injunctive order compelling the defendants in the future to disclose material facts concerning their involvement in securities that the defendants recommended through their publications. *Id.*

[38] *Id.* at 193-94. *But see* text accompanying notes 86-110 *infra*.

[39] 446 U.S. at 693-95. The *Aaron* Court observed that the language in § 206(2), which proscribes "any . . . practice . . . which operates. . . . as a fraud or deceit," focuses on the effect of an action, rather than on the intent of an investment adviser. *Id.* at 694; *see* note 36 *supra*. In addition, the *Capital Gains* Court concluded that the legislative history of the '40 Act indicated that Congress did not intend to require proof of scienter. 375 U.S. at 191-92. The *Capital Gains* Court noted that the congressional reports expressed Congress' desire to eliminate "all conflicts of interest which incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested." *Id.*

[40] 446 U.S. at 694. An investment adviser owes a fiduciary duty to his client not to deceive the client. *See* 375 U.S. at 190 (quoting *Hearings on S. 3580 before Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. 719 (1939) (relationship between investment adviser and client based on "trust and confidence")). The *Capital Gains* Court acknowledged that intent to deceive was not an element of a common law fraud action against a fiduciary. 375 U.S. at 193-94; *see* note 96 *infra*.

[41] 446 U.S. at 694-95. Section 10(b) extends to the acts of "any person . . . in connection with the purchase and sale of securities." *See* note 3 *supra*. Section 206, however, prohibits

In determining whether scienter is an element in SEC injunctive actions under section 17(a), the Supreme Court examined the specific language in the three subparagraphs of section 17(a).[42] Section 17(a)(1) prohibits the use of "any device, scheme, or artifice to defraud" in the sale of securities.[43] Reasoning that the terms "device," "scheme," and "artifice" connote knowing or intentional practices, the *Aaron* Court concluded that scienter is an element of proof in SEC actions to enjoin violations of section 17(a)(1).[44] The Court noted further that the term "device" figured prominently in the *Hochfelder* determination that a scienter requirement applies in SEC injunctive actions under section 10(b).[45]

The Supreme Court reached an opposite result, however, in considering whether the SEC must prove scienter to establish a violation under the second and third subparagraphs of section 17(a).[46] Section 17(a)(2) prohibits a seller from obtaining money or property by means of a misstatement or omission of a material fact.[47] The *Aaron* Court reasoned that the plain meaning of the language of section 17(a)(2) did not suggest a scienter requirement.[48] The Court noted that the *Hochfelder* Court conceded that similar language appearing in rule 10b-5(b) could be read to proscribe any misstatement, omission, or conduct, whether intentional or not, that had a deceptive effect upon the investing public.[49] In addition, the *Aaron* Court found section 17(a)(3) devoid of a scienter requirement.[50] Section 17(a)(3) prohibits any person from participating in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[51] The Court reasoned that this particular provision focuses on the effect of the defendant's conduct on investors, rather than on the defendant's state of mind.[52]

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certain acts between an "investment adviser" and "any client or prospective client." *See* note 36 *supra.*

[42] *See* 446 U.S. at 695-97; text accompanying notes 43-52 *infra.*

[43] *See* note 8 *supra.*

[44] 446 U.S. at 695-96.

[45] *Id.* at 696.

[46] *Id.* at 696-97.

[47] *See* note 8 *supra.*

[48] 446 U.S. at 696 (citing 3 L. LOSS, SECURITIES REGULATION 1442 (2d ed. 1961)).

[49] 446 U.S. at 696. Rule 10b-5(b) prohibits a person from making any untrue statement of a material fact or omitting to state a material fact necessary to make statements made not misleading. *See* note 4 *supra.* The *Hochfelder* Court acknowledged that this specific terminology, if viewed in isolation, could proscribe either negligent or intentional behavior. 425 U.S. at 212. The Court, however, did not find that the Commission's language in rule 10b-5 controlled the construction of the rule. *Id.* at 212-14. The Commission adopted rule 10b-5 pursuant to authority granted in § 10(b). The scope and intent of § 10(b) controls the construction of rule 10b-5. *See* text accompanying notes 29-33 *supra.*

[50] 446 U.S. at 696-97.

[51] *See* note 8 *supra.*

[52] 446 U.S. at 696-97. The *Aaron* Court construed the language in § 17(a)(3) according to the *Capital Gains* Court's construction of similar language in § 206(2). *Id.* at 697. In *Capital Gains*, the Supreme Court noted that § 206(2) does not require a "showing [of] deliberate dishonesty as a condition precedent to protecting investors." 375 U.S. at 200. The *Aaron*

The Supreme Court in *Aaron* held further that sections 20(b) and 21(d), which authorize the SEC to seek injunctive relief against violations of the '33 and '34 Acts, are devoid of any culpability requirement.[53] To obtain an injunction under these two provisions, the SEC must show that a person is violating or about to violate a substantive provision of the '33 and '34 Acts or a rule promulgated thereunder.[54] The Court noted that to prove a violation for the purpose of injunctive relief under section 20(b) or section 21(d), the SEC must establish all elements of a substantive violation, including scienter when necessary.[55] Thus, although sections 20(b) and 21(d) do not have a culpability requirement, the SEC will have to prove scienter to enjoin violations of a substantive provision requiring scienter. The Supreme Court suggested that even under provisions that lack a scienter requirement the SEC would have to make a showing equivalent to scienter to obtain any injunction, because courts assess a defendant's propensity to commit future violations of a provision on the basis of his prior intentional misconduct.[56]

The Supreme Court in *Aaron* reasoned correctly that statutory language and underlying legislative history, rather than policy considerations, should control the construction of the federal securities laws. The logical starting point in construing any statute is with an examination of the provision's specific language.[57] When the terms define clearly the prerequisites for an action pursuant to the statute, policy considerations, regardless of their appeal, should not contradict the statute's express wording.[58] *Hochfelder* offers a sound interpretation of

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Court observed further that the Supreme Court in United States v. Naftalin, 441 U.S. 768, 774 (1979), noted that each subparagraph of § 17(a) proscribed a distinct type of conduct. 446 U.S. at 697. The *Aaron* Court concluded that in light of the clear language in § 17(a) prescribing a scienter requirement only under § 17(a)(1), only a definite expression of a contrary congressional intent in the legislative history of § 17(a) would justify a holding that the language did not control. *Id.* The *Aaron* Court rejected the SEC's argument that the legislative history of § 17(a) indicated Congress' intent to require negligence under all three subparagraphs of § 17(a). *Id.* at 697-700. *But see* text accompanying notes 72-76 *infra.*

[53] 446 U.S. at 700.

[54] *Id.* at 700-01; *see* notes 15-16 *supra.*

[55] 446 U.S. at 701. After *Aaron*, the SEC may establish a violation of § 17(a)(1), § 10b, and rule 10b-5, sufficient to warrant injunctive relief, only upon a showing of scienter. The SEC may establish a violation of § 17(a)(2) and § 17(a)(3), however, upon proof of a defendant's negligence. Proving a substantive violation does not necessarily establish the other element necessary for issuance of an injunction, that future violations are likely to occur. *See* text accompanying notes 136-141 *infra.*

[56] 446 U.S. at 701; *see* text accompanying notes 138-141 *infra.*

[57] *See* Helvering v. New York Trust Co., 292 U.S. 455, 464 (1934) (construction of statute unnecessary when language is unambiguous); United States v. Hartwell, 73 U.S. (6 Wall.) 385, 396 (1867) (clear language of statute is conclusive).

[58] *See* Rubin v. United States, 101 S. Ct. 698, 701 (1981) (no further judicial inquiry necessary when terms of statute unambiguous and court's reading of statute is consistent with legislative history); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976) (language and legislative history of § 10(b) dispositive of the appropriate standard of liability); United States v. Oregon, 366 U.S. 643, 648 (1961) (language of statute controls when clear).

the language of section 10(b) and rule 10b-5. Although the terms "device" and "deceptive" are somewhat ambiguous, the words "manipulative" and "contrivance" connote clearly a scienter requirement.[59] Moreover, *Hochfelder's* interpretation of the language and legislative history of section 10(b) and rule 10b-5 applies with equal force in support of a scienter standard in SEC injunctive actions. At the time Congress enacted section 10(b), Congress did not contemplate the judicially implied private cause of action now recognized under section 10(b).[60] Thus, Congress intended initially that section 10(b) apply only in Commission enforcement proceedings.[61] If the language and legislative history of section 10(b) prescribe a scienter requirement in private damage actions, the same culpability standard must apply, therefore, in SEC injunctive actions under section 10(b). Since the Commission has authority to adopt only rules and regulations that accord with the requirements of the authorizing statute, a scienter requirement under section 10(b) dictates a similar standard under rule 10b-5.[62]

Contrary to the *Aaron* Court's conclusion, the statutory language of section 17(a)(1) does not provide clear guidance on the provision's proper construction. Section 17(a)(1) proscribes the use of "any device, scheme, or artifice to defraud" in the sale of securities.[63] The Supreme Court acknowledged possible ambiguity surrounding the word "defraud"[64] but

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[59] *See* Armour Packing Co. v. United States, 209 U.S. 56, 71 (1908) (word "device" need not connote scienter); People v. Wahl, 3 Cal. App. Supp. 196, 197, 100 P.2d 550, 551 (Super. Ct. 1940) ("deceptive" does not necessarily imply intent to deceive). The *Hochfelder* Court noted that the word "manipulative" is a term of art when used in connection with securities markets to connote intentional or willful conduct. 425 U.S. at 199; *see* BLACK'S LAW DICTIONARY 868 (5th ed. 1979). The term "contrivance" means a device arranged to deceive. *See* BLACK'S LAW DICTIONARY 298 (5th ed. 1979).

[60] *See* 425 U.S. at 196. Congress expressly authorized the SEC to seek injunctive relief, pursuant to § 21(d), for violations of § 10(b). *See* note 16 *supra*. Nothing in the language of § 10(b), nor in the language of any other provision, indicates that a private cause of action exists for violation of § 10(b). Further, the legislative history of § 10(b) is devoid of any reference to a private cause of action. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729 (1975) (no indication in history of § 10(b) that Congress considered a private cause of action); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. L. REV. 627, 656-60 (1963) (questioning appropriateness of private cause of action under § 10(b) because unsupported in legislative history). In § 9 of the '34 Act, however, Congress expressly created a private cause of action against violations of the provisions of § 9. 15 U.S.C. § 78i(e) (1976). Despite any doubt concerning the appropriateness of a private cause of action under § 10(b), the remedy is well established. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972); Superintendent of Ins. v. Banker's Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[61] *See* 425 U.S. at 196; note 60 *supra*.

[62] *See* 425 U.S. at 212-14; Dixon v. United States, 381 U.S. 68, 74 (1965); Manhatten Gen. Equip. Co. v. Comm'r, 297 U.S. 129, 134 (1936).

[63] *See* note 8 *supra*.

[64] 446 U.S. at 696. The definition of the word "fraud" controls the construction of the term "defraud." *See* BALLENTINE'S LAW DICTIONARY 324-25 (3d ed. 1969). At common law, fraud had a different meaning in equity than in law. In equity, the concept of fraud did not encompass scienter. In an action for fraud in law, scienter was an essential element of proof. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963).

concluded, nonetheless, that the terms "device," "scheme," and "artifice" connoted knowing or intentional behavior.[65] Although the term "device" was among the terminology in *Hochfelder* found to support a scienter requirement under section 10(b), the word appeared in conjunction with the terms "manipulative," "deceptive," and "contrivance."[66] The additional terms provide substantial support to the finding of a scienter standard under section 10(b). Coupled with the words "scheme" and "artifice," however, the term "device" in section 17(a)(1) does not necessarily imply conduct constituting scienter.[67] In fact, the Supreme Court recognized in construing the language of the Elkins Act[68] that the term "device" could connote less culpable behavior than scienter.[69] To interpret section 17(a)(1), therefore, determining the proper construction of the terms "scheme" and "artifice" is essential. Although these two words may refer to a devious course of action, the terms also may define an organized plan or strategy.[70] While a "plan" or "strategy" implies a degree of knowledge on behalf of an actor, these terms are not as suggestive of intentional misconduct as the phrases "manipulative" and "willfully" that Congress employed in securities laws requiring scienter.[71]

Furthermore, the legislative history of section 17(a) does not clarify whether Congress intended to prescribe a scienter requirement. As originally drafted, section 17(a) included the term "willfully" among its provisions.[72] Congress also considered adding the phrase "with intent to

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[65] 446 U.S. at 696.

[66] *See* 425 U.S at 197-99; note 3 *supra*. The *Hochfelder* Court singled out only the term "manipulative" as especially significant in proving the existence of a scienter requirement in private actions under § 10(b). 425 U.S. at 199. The Court noted that the word manipulative was a "term of art" in the securities field that connotes intentional or willful conduct for the purpose of deceiving investors. *Id.*

[67] *See* 73 AM. JUR. 2d *Statutes* § 213 (1974) (meaning of particular terms in statute ascertained by reference to words associated with them in statute).

[68] 49 U.S.C. § 41 (1976). The Elkins Act proscribes the use of certain devices by shippers in interstate commerce to effect a rebate, concession, or rate discrimination. *Id.*

[69] *See* Armour Packing Co. v. United States, 209 U.S. 56, 71 (1908) (meaning of term "device" not limited to dishonest or fraudulent conduct). The legislative history of the '34 Act provides further support that the word "device" does not necessarily connote scienter. In fact, Congress used the term as a synonym for the word "practice" in the Senate version of § 17(a)(1). *See* S. Rep. No. 792, 73d Cong., 2d Sess., 18 (1934); Aaron v. SEC, 446 U.S. 686, 707 (1980) (Blackmun, J., concurring in part and dissenting in part). The term "device" also appears in § 15(c)(1) of the '34 Act, 15 U.S.C. § 78o(c)(1) (1976). The legislative history of § 15 explicitly indicates that the provision applies to negligent conduct. *See* 17 C.F.R. § 240.15cl-2 (1980); H.R. Rep. No. 2307, 75th Cong., 2d Sess., 10 (1938).

[70] *See* 446 U.S. at 696 n.13; BLACK'S LAW DICTIONARY 103, 1206 (5th ed. 1979).

[71] *Compare* § 9(e) of the '34 Act, 15 U.S.C. § 78i(e) (1976) ("any person who willfully participates") *and* § 10(b), 15 U.S.C. 78j(b) (1976) ("any person . . . [t]o employ . . . any manipulative or deceptive device or contrivance") *with* § 17(a)(1), 15 U.S.C. 77q(a)(1) (1976) ("a person . . . [t]o employ any device, scheme, or artifice to defraud").

[72] 446 U.S. at 697-98. The current § 17(a) first appeared in Congress as § 13. This provision prohibited any person "willfully to employ any device, scheme, or artifice to defraud . . ."

defraud" to the statutory language in section 17(a).[73] Section 17(a) does not contain any of the above terminology.[74] In addition, the legislative history contains no explanation for the exclusion of the language. The *Aaron* Court reasoned that plain meaning of the language in section 17(a)(1) made the inclusion of this terminology unnecessary.[75] Another reasonable explanation for the absence of this language in the final version is that Congress considered and rejected a scienter requirement for section 17(a)(1).[76]

Assuming the *Aaron* Court decided correctly that the language of section 17(a)(1) suggests a scienter requirement, an equally persuasive policy argument supports application of a scienter standard under all three subparagraphs of section 17(a). Section 17(a) applies only to the misrepresentations of sellers of securities.[77] Any action brought against a seller under section 17(a) may be brought in conjunction with an action under section 10(b), which applies to both purchasers and sellers of

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H.R. 4314, 73d Cong., 1st Sess. (March 29, 1933); S. 875, 73d Cong., 1st Sess. (March 29, 1933); *see* 446 U.S. at 697-98. The House Committee on Interstate and Foreign Commerce and the Senate Committee on Banking and Currency held hearings on § 13. Subsequently, the House Committee adopted a version of § 13 with the word "willfully" deleted. *See* H.R. 5480, 73d Cong., 1st Sess., § 16(a) (May 4, 1933). The legislative history is devoid of any reason for the deletion. Congress enacted the House version, with minor changes, into law as § 17. *See* 446 U.S. at 698 & n.16.

[73] 446 U.S. at 699. During hearings on the current § 17(a), the House Committee rejected a proposal to modify the terminology "to employ any device, scheme, or artifice" with the phrase "with intent to defraud." *See Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 1st Sess., 146 (1933).

[74] *See* note 8 *supra*.

[75] 446 U.S. at 699-700. The SEC argued that Congress' deliberate exclusion of the term "willfully" and the phrase "with intent to defraud" in § 17(a) indicated that Congress considered and rejected a scienter requirement under § 17(a). *Id.* at 699. The *Aaron* Court declined to draw the inference required by the SEC's argument in the absence of an express legislative intent in support of the inference. *Id.* The Court further suggested that the plain meaning of the terms in § 17(a)(1) made the excluded phrases redundant. *Id.*

[76] In *Aaron*, the SEC argued that Congress rejected a scienter requirement under § 17(a). 446 U.S. at 699. The Court found the plain meaning of the statute controlling. *Id.* at 699-700; note 75 *supra*. The ambiguous nature of the terms in § 17(a)(1), which the *Aaron* Court found to suggest a scienter requirement, weakens, however, the Court's assertion that the clear language in § 17(a)(1) made the inclusion of the phrases "willfully" and "with intent to defraud" unnecessary. *See* text accompanying notes 63-71 *supra*. Moreover, dissenting Justice Blackmun noted that the House Conference Report, discussing the differences between the original and final House Committee version of § 17(a), indicated that the final version included "minor and clarifying changes" intended "to make clear and effective the administrative procedure provided for and to remove uncertainties" concerning the SEC's powers. 446 U.S. at 706 n.1 (Blackmun, J., concurring in part and dissenting in part); *see* H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess., 24 (1933). One of the changes made was the exclusion of the term "with intent to defraud." Justice Blackmun suggested that if Congress intended a scienter requirement under § 17(a)(1), retention, instead of exclusion, of the phrase "with intent to defraud" would have furthered Congress' goal of clarifying § 17(a). 446 U.S. at 706 n.1 (Blackmun, J., concurring in part and dissenting in part).

[77] *See* 446 U.S. at 687; note 8 *supra*.

securities.[78] A scienter requirement in SEC injunctive actions against a seller's violation of section 10(b) is meaningless, however, if the SEC may enjoin the negligent misrepresentations of the seller under sections 17(a)(2) and 17(a)(3). The effectiveness of the strict scienter approach under section 10(b), therefore, depends on whether sellers are subject to a similar requirement under section 17(a). The *Aaron* Court's determination that scienter is not an element of section 17(a)(2) and section 17(a)(3) violations undermines the scienter requirement in section 10(b) by creating a loophole for the SEC to enjoin the negligent misrepresentations of sellers.[79]

In *Aaron*, the SEC relied heavily on the Supreme Court's earlier decision in *SEC v. Capital Gains Research Bureau, Inc.*[80] to support their argument that negligence is the proper standard of culpability in injunctive actions.[81] In *Capital Gains*, policy considerations persuaded the Court that a negligence standard should apply in Commission enforcement proceedings against violations of section 206(2) of the '40 Act.[82] The *Capital Gains* Court did not rely on the specific language in the '40 Act, but focused instead on the Act's legislative history.[83] The Investment Advisors Act of 1940 regulates the fiduciary relationship between an investment adviser and his client.[84] The legislative history of the Act indicates that Congress desired to prevent certain violations of this fiduciary duty regardless of the violating actor's state of mind.[85] Further, the *Capital Gains* Court held that a distinction between common law fraud in law and in equity implied that the Commission should not be held to a strict scienter standard.[86] In common law fraud and deceit actions the elements of proof for equitable relief were less exacting than the elements in an action for money damages where proof of intent to deceive was generally necessary.[87] Equitable remedies at common law often were less detrimental to a defendant than monetary damages aimed

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[78] *See* 446 U.S. at 687; note 3 *supra*.

[79] *See* Aaron v. SEC, 446 U.S. 680, 715 (1980) (Blackmun, J., concurring in part and dissenting in part) (holding drives wedge between provisions of § 10(b) and § 17(a) and says "henceforth only the seller's negligent misrepresentations may be enjoined").

[80] 375 U.S. 180 (1963); *see* note 37 *supra*.

[81] 446 U.S. at 691-95.

[82] *See* 375 U.S. at 186-95; text accompanying notes 82-88 *infra*.

[83] *See* 375 U.S. at 186-92; note 39 *supra*.

[84] *See* 375 U.S. at 191; notes 39 & 40 *supra*.

[85] *See* 375 U.S. at 191-92; note 39 *supra*.

[86] *See* 375 U.S. at 192-95.

[87] *See* 446 U.S. at 693. An action for misrepresentation or deceit at common law required proof of scienter. *See* Derry v. Peek, 14 App. Cas. 337, 339 (1889); 3 L. LOSS, SECURITIES REGULATION, 1431 (2d ed. 1961). Equitable relief, however, could issue upon a showing of negligence or innocent mistake. *See* Redgrave v. Hurd, 20 Ch. D. 1, 12 (Ch. App. 1881); 3 J. POMEROY, EQUITY JURISPRUDENCE §§ 884, 885 (5th ed. 1941) [hereinafter cited as POMEROY].

at punishing the defendant for wrongdoing.[88] Reasoning that an SEC action for injunctive relief would have only a "mild prophylactic" effect on the defendant as compared to the punitive effects associated with monetary damages, the *Capital Gains* Court concluded that proof of scienter was not a prerequisite to the SEC's injunctive action.[89]

The *Aaron* Court reasoned correctly that the *Capital Gains* analysis of section 206(2) should not control the construction of section 10(b).[90] Section 206(2) proscribes any practice "which operates as a fraud or deceit."[91] Nothing in the language of section 206 implies specifically the existence of a scienter requirement. In contrast, the terminology appearing in section 10(b) connotes scienter.[92] Moreover, the *Capital Gains* Court took guidance from the legislative history, which indicated Congress' lack of concern with an investment adviser's specific state of mind under section 206(2).[93] Although the clear language in section 10(b) makes reliance on the legislative history unnecessary, the legislative history of section 10(b), nonetheless, indicates a scienter requirement.[94] *Capital Gains'* reliance on the distinction between fraud in law and in equity also should not determine the proper culpability standard in all SEC injunctive actions. *Capital Gains* involved a provision regulating a fiduciary relationship.[95] Even in a common law fraud action for damages, the plaintiff need not prove scienter when the defendant owed a fiduciary duty to the deceived party.[96] Moreover, the *Capital Gains* Court's assumption that an injunction is only a "mild prophylactic" remedy, lacking the punitive effect of monetary damages, ignores the possible consequences that may result from an injunction.

The direct effect of an SEC injunction is to order the defendant to correct any misconduct or refrain from future conduct that violates or may violate the securities laws.[97] An injunction, however, also may have

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[88] *See* 446 U.S. at 693. At common law, equitable relief resulted in undoing the transaction. Common equitable remedies were recission, reformation of contract, and equitable liens. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS, 387-88 (4th ed. 1971) [hereinafter cited as PROSSER]. Injunctive relief was available also, but extended only to past misrepresentations, not to prohibit future misconduct. *See* POMEROY, *supra* note 87, at 577.

[89] 375 U.S. at 193-95. The Supreme Court's implicit equating of equitable remedies at common law with an SEC injunction ignores the harsher effects of an SEC injunction. *See* text accompanying notes 97-110 *infra*.

[90] *See* text accompanying notes 34-41 *supra*.

[91] *See* note 36 *supra*.

[92] *See* text accompanying notes 29, 30 & 59 *supra*.

[93] *See* text accompanying notes 83-85 *supra*.

[94] *See* text accompanying notes 29-30 *supra*.

[95] *See* 375 U.S. at 190-91. *See* note 40 *supra*.

[96] *See* 375 U.S. at 192-94. The *Capital Gains* Court observed that in a damage suit between parties to an arm's length transaction, intent and injury are necessary elements of proof. *Id.* at 192. The Court noted, however, that in a similar suit against a fiduciary, proof of these elements was unnecessary. *Id.* at 193-94. *See also* PROSSER, *supra* note 88, at 534-535 (fiduciary has affirmative duty not to act negligently).

[97] *See* E. GADSBY, 11A BUSINESS ORGANIZATIONS: THE FEDERAL SECURITIES EXCHANGE

indirect punitive effects upon a defendant. A defendant that fails to comply with any injunctive order may subject himself to prosecution for civil or criminal contempt.[98] Even if the defendant complies with the injunction, he may lose certain rights and privileges available to him under the '33 Act and the Investment Company Act of 1940.[99] A defendant subjected to an injunction also may be disqualified from professional practice before the SEC,[100] or have his broker-dealer registration revoked or suspended.[101] When the enjoined defendant is a corporation, the SEC may seek ancillary relief by means of disgorgement of profits,[102] or appointment of a receiver,[103] special counsel, or interim director to ensure the corporation's compliance with the securities laws.[104] An injunction against any defendant may expose the defendant to civil liability in private damage actions.[105] The cost of defending against an SEC injunction and any resulting civil liability is often staggering.[106] Moreover, an individual's or firm's reputation is essential to success in the in-

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ACT OF 1934 § 9.03[1] n.1 (1980) [hereinafter cited as GADSBY] (discussing power of courts upon application by SEC to demand defendant's compliance with securities laws).

[98] *See* 18 U.S.C. § 401 (1976); Matthews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 946-50 (1971) [hereinafter cited as Matthews].

[99] The SEC may exempt certain classes of securities from registration requirements. *See* 17 C.F.R. §§ 230.251-263 (1980). An issuer of securities loses this exemption privilege by operation of law if any official of the issuer or underwriter is enjoined from violating the securities laws. *Id.* § 230.252(d). The SEC may lift or waive the disqualification after application and hearing on the matter. *Id.* § 230.252(f). Section 9(a)(2) of the Investment Company Act, 15 U.S.C. 80a-9(a)(2) (1976), bars any party from serving or acting in any capacity with an advisory board, investment adviser, depositor, or underwriter of a registered investment firm if that party is subject to an SEC injunction. The SEC also may remove this disqualification. § 9(c) of the Investment Company Act of 1940, 15 U.S.C. § 80a-9(c) (1976).

[100] 17 C.F.R. § 201.2(e)(3)(i) (1980). The SEC may issue an injunction that temporarily suspends the privilege of practicing before the SEC for any attorney, accountant, engineer, or other professional or expert who is enjoined permanently from violating the securities laws. *Id.* The temporary suspension becomes permanent unless the suspended party petitions for a hearing. *Id.* § 201.2(e)(3)(ii). In the hearing, the party cannot contest the prior injunction. *Id.* at § 201.2(e)(3)(iv). The only issues in the hearing are whether the injunction is permanent and whether disqualification is proper. *Id.*

[101] 15 U.S.C. 78o(b)(4), (5) (1976); 15 U.S.C. 80b-3(e), (f) (1976); *see* James F. Morrisey, 25 S.E.C. 372, 381 (1947) (SEC registration revoked); Charles C. Wilson, 1 S.E.C. 402, 407 (1936) (registration refused).

[102] *See* SEC v. Blatt, 583 F.2d 1325, 1327, 1335 (5th Cir. 1978); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307 (2d Cir. 1971).

[103] *See* SEC v. Charles Plohn & Co., 443 F.2d 376, 379 (2d Cir. 1970); SEC v. Bartlett, 422 F.2d 475, 476 (8th Cir. 1970).

[104] *See* Comment, *Equitable Remedies In SEC Enforcement Actions*, 123 PA. L. REV. 1188, 1204-10 (1975).

[105] *See* Parklane Hosiery Co., Inc. v. Shore, 439 U.S. 322, 331-32 (1979) (defendants in damage action collaterally estopped from relitigating misleading proxy statement issue determined in prior injunctive action).

[106] *See* Griffin, *The Beleaguered Accountants: A Defendant's Viewpoint*, 62 A.B.A.J. 759, 761 (1976) (noting enormous expense of defending SEC fraud suits).

vestments field.[107] The adverse publicity that surrounds the issuance of an injunction may harm a defendant's personal and business reputation.[108] Even if the SEC fails to obtain an injunction, the defendant must conduct business under allegations of fraudulent behavior until the court denies the injunction.[109] The punitive aspects of an SEC injunction, therefore, weaken the policy arguments in favor of holding the SEC to a negligence standard.[110]

The Supreme Court's reasoning that scienter is an element in SEC injunctive actions under section 17(a)(1), section 10(b), and rule 10b-5 may affect subsequent courts' construction of the prerequisites to injunctive relief under other antifraud provisions with language suggestive of a scienter requirement.[111] For example, section 9 of the '34 Act regulates practices that manipulate the market price of securities.[112] Under section 9(e), Congress established a scienter requirement in private actions by authorizing expressly a cause of action for damages against any person who "willfully" participates in an act or transaction that violates the provisions of section 9.[113] Although courts have not determined whether scienter is an element in SEC injunctive actions under section 9, the language of section 9(a) connotes clearly a scienter requirement. Section 9(a) prohibits certain acts performed for the purpose of manipulating the price of securities.[114] Since the Supreme Court has found the term "manipulative" to be a term of art in the securities field that connotes scienter,[115] courts should require the SEC to prove scienter as a prerequisite to injunctive relief against section 9(a) violations.[116]

A scienter requirement is appropriate also in SEC injunctive actions under the tender offer provisions of section 14(e) of the '34 Act.[117] Section 14(e) prohibits a person from engaging in any fraudulent, deceptive, or

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[107] *See* GADSBY, *supra* note 97, at § 9.03[1] n.39.

[108] *See* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1102 (2d Cir. 1972); SEC v. Harwyn Indus. Corp., 326 F. Supp. 943, 957 (S.D.N.Y. 1971); Note, *Injunctive Relief in SEC Civil Actions: The Scope of Judicial Discretion*, 10 COLUM. J.L. & SOC. PROB. 328, 342 (1974).

[109] *See* GADSBY, *supra* note 97, at § 9.03[1] n.39.

[110] *See* text accompanying notes 81-89 *supra*.

[111] *See* text accompanying notes 22-25 *supra*.

[112] 15 U.S.C. § 78i (1976).

[113] *Id.* § 78i(e); *see* 425 U.S. at 207.

[114] 15 U.S.C. § 78i(a) (1976).

[115] *See* 425 U.S. at 199; note 59 *supra*. Congress entitled § 9 "Manipulation of Security Prices." The provisions of § 9 proscribe certain manipulative acts that affect the price of securities. For example, § 9(a)(1) prohibits any person from performing certain acts "[f]or the purpose of creating a false or misleading appearance of active trading" in any registered security. 15 U.S.C. § 78i(a)(1). Section 9(a)(2) prohibits acts effected "for the purpose of inducing the purchase or sale" of any security. *Id.* § 78i(a)(2). Similar language proscribing intentional acts that manipulate the market price of a security appears in subsections (3)-(6) of § 9(a). *Id.* § 78i(a)(3)-(6).

[116] *See* SEC v. Aaron, 446 U.S. 680, 701 (1980) (SEC must prove scienter as prerequisite to injunctive relief when scienter is element of substantive violation).

[117] 15 U.S.C. § 78n(e) (1976).

manipulative act or practice in connection with a tender offer.[118] This language in 14(e) is similar to the language in section 10(b) and rule 10b-5 that the *Aaron* Court recognized to prescribe scienter.[119] Courts have held that scienter is an element of private damage actions under section 14(e).[120] Since the language and legislative history of section 14(e) does not suggest that Congress intended the scienter requirement to apply only in private damage actions, the scienter standard should extend to SEC injunctive actions under section 14(e).[121]

The *Aaron* Court's reasoning that the language and legislative history of a statute control the construction of a substantive provision should not support, however, a scienter standard in SEC injunctive actions where a court, for policy reasons only, determines that a substantive provision without statutory language connoting scienter requires proof of scienter in private actions. Section 14(a) of the '34 Act prohibits a person from violating SEC rules and regulations adopted pursuant to the proxy solicitation provisions of section 14(a).[122] Rule 14a-9(a), promulgated under section 14(a), prohibits solicitation by means of proxy or other communication containing a statement that "is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."[123] Nothing in the language of section 14(a) or rule 14a-9(a) indicates a scienter requirement.[124] In fact, the terminology in the two provisions is similar to the language in section 17(a)(2) of the '33 Act, which the *Aaron* Court found not to manifest a scienter standard.[125] Several courts have held negligence to be the proper culpability standard in judicially implied private damage actions under section 14(a).[126] The

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[118] *Id.*

[119] *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 362 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). *Compare* 15 U.S.C. § 78n(e) (1976) *with* 15 U.S.C. § 78j(b) (1976); text accompanying notes 28-33 *supra.*

[120] *See* Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 430 (6th Cir. 1980); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363-64 (2d Cir. 1973). *See also* A&K R.R. Materials, Inc. v. Green Bay & W.R.R. Co., 437 F. Supp. 636, 642 (E.D. Wis. 1977) (scienter is element in private injunctive action under § 14(e)).

[121] *See* 446 U.S. at 701. The language and legislative history of a statute are the same regardless of the plaintiff or the nature of an action. 446 U.S. at 691. Courts have found the language and legislative history of § 14(e) to prescribe a scienter requirement in private causes of action under § 14(e). *See* text accompanying note 120 *supra.* Accordingly, the same language and legislative history should support a scienter standard in SEC injunctive actions, unless restricted by Congress to only private damage actions.

[122] 15 U.S.C. § 78n(a) (1976).

[123] 17 C.F.R. § 240.14a-9(a) (1980).

[124] *See* Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 429 (6th Cir. 1980).

[125] *See* text accompanying notes 46-47 *supra.*

[126] *See* Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 777-78 (3d Cir. 1976); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300-01 (2d Cir. 1973); Berman v. Thomson, 403 F. Supp. 695, 699 (N.D. Ill. 1975).

Sixth Circuit in *Adams v. Standard Knitting Mills, Inc.*,[127] recently established, however, a scienter standard for violations of section 14(a) by outside corporate directors and accountants, despite the clear language in section 14(a) indicating a negligence standard.[128] In *Adams*, the Court noted that a negligence standard in private damage actions under section 14(a) may subject directors and accountants to substantial monetary liability for minor, unintentional mistakes involving proxies.[129] Reasoning that an outside director or accountant does not directly benefit from a proxy vote and is not in privity with stockholders, the *Adams* court concluded on policy grounds that outside directors and accountants should not incur liability under section 14(a) or rule 14a-9(a) for negligent mistakes.[130] These policy considerations that support a scienter standard in private damage actions under section 14(a) or rule 14a-9(a) should not control, however, the construction of the proper culpability standard in SEC enforcement proceedings, which impose no monetary liability upon a negligent defendant. Moreover, the clear language of a statute, not policy considerations, should control the construction of a substantive provision in express actions.[131] Although a court may inject a scienter standard in implied private damage actions under section 14(a), a court should not inject a scienter requirement in express SEC injunctive actions in the absence of language in section 14(a) suggesting scienter as the proper culpability standard for liability.

Courts and commentators have suggested that imposition of a scienter requirement will increase the SEC's burden in injunctive actions and impair the effectiveness of the SEC in providing protection to the investing public.[132] The practical effect of a scienter standard in SEC

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[127] 623 F.2d 422 (6th Cir. 1980).

[128] *Id.* at 428.

[129] *See id. But see* Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 777-78 (3d Cir. 1976) (negligence proper standard under § 14(a) for outside directors).

[130] 623 F.2d at 428. The *Adams* court noted that federal courts created the private right of action under § 14, and thus the courts must consider the consequences of their rulings and mold liability fairly to account for the parties' circumstances. *Id.* Reasoning that rule 14a-9 is similar to rule 10b-5 because both rules require materiality instead of reliance, the *Adams* court concluded that the scienter standard of § 10(b) should apply to accountants under § 14(a) and rule 14a-9(a). *Id.* at 429. The court further observed that language in the legislative history of § 14 (a) suggested that Congress hoped § 14(a) would protect investors against the "promiscuous" solicitation of proxies by "irresponsible outsiders" and "unscrupulous corporate officials" who conceal and distort facts. *Id.* The *Adams* court construed this language in the legislative history to connote a scienter requirement for corporate outsiders. *Id.* at 430. *Contra*, Gould v. American Hawaiian Steamship Co., 351 F. Supp. 853, 858-864 (D. Del. 1972), *aff'd*, 535 F.2d 761 (3d Cir. 1976) (legislative history of § 14(a) does not suggest a scienter requirement).

[131] *See* United States v. Oregon, 366 U.S. 643, 648 (1961); note 57 *supra*.

[132] *See* 375 U.S. at 200; SEC v. Aaron, 605 F.2d 612, 621 (2d Cir. 1979); Note, *Securities Regulation*, 5 J. CORP. L. 377, 381 (1980) [hereinafter cited as *Securities Regulation*]; Note, *The Scienter Requirement in an SEC Enforcement Action—Should Equity Control?* 5 DAYTON L. REV. 217, 230 (1980).

injunctive actions may not be this severe. In fact, the scienter requirement deprives only investors harmed by negligent misrepresentations of protection.[133] Investors harmed by intentional misrepresentations do not lose any protection since intentional misconduct is enjoinable under either a negligence or scienter standard. Moreover, a defendant who acts negligently and causes harm to innocent investors may remain susceptible to liability in common law negligence actions for damages.[134] Further, a defendant has incentive to avoid fraudulent conduct, whether intentional or negligent, because he may cause harm to his reputation in the financial investments field and thereby affect his business interests.[135]

In addition, a scienter standard does not impose a new disability upon the Commission, since courts generally have denied injunctions when the defendant acted negligently.[136] Sections 20(b) and 21(d) authorize the SEC to seek an injunction only when the SEC demonstrates that a person is engaged or about the to engage in an act that the federal securities laws prohibit.[137] Although neither section 20(b) nor section 21(d) dictates the necessity of establishing a prior violation as a prerequisite to injunctive relief, courts often have declined to grant an injunction unless the SEC makes a prima facie showing that a violation occurred and that the violation is likely to recur.[138] In discussing the

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[133] *See Securities Regulation, supra* note 132, at 392.

[134] *Cf.* SEC v. Koracorp Indus., Inc., 575 F.2d 692, 702 & n.5 (9th Cir. 1978) (Carter, J., concurring), *cert. denied*, 439 U.S. 953 (1978) (noting that defendants possibly subject to common law negligence suits for diversion of corporate funds); *see* Brodsky, *Suing Brokerage Firm for Negligence Under State Law*, N.Y.L.J., Sept. 21, 1977, at 1, col. 1.

[135] *See* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1102 (2d Cir. 1972) (court recognition of importance of reputation).

[136] *See* SEC v. Koracorp Indus., Inc., 575 F.2d 692, 700-02 (9th Cir. 1978) (regardless whether § 10(b) and rule 10b-5 violated by negligent conduct, injunction properly denied where no evidence of future misconduct); SEC v. Management Dynamics, Inc., 515 F.2d 801, 810-811 (2d Cir. 1975) (despite application of negligence standard, injunction improper unless defendant knew or should have known statements would mislead); SEC v. Bangor Punta Corp., 331 F. Supp. 1154, 1161-63 (S.D.N.Y. 1971) (injunction inappropriate where defendant's violations not for purpose of misleading investors), *modified on other grounds sub nom.*, Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F. 2d 341 (2d Cir.), *cert. denied*, 414 U.S. 924 (1973); SEC v. Harwyn Indus. Corp., 326 F. Supp. 943, 955 (S.D.N.Y. 1971) (negligent violation could not support finding of likelihood of future misconduct); Brodsky, *Willfulness in SEC Enforcement Proceedings*, N.Y.L.J., Dec. 15, 1976, at 1, col. 1, at 2, col. 3 (noting tendency of courts to deny injunctive relief absent evidence of scienter).

[137] *See* notes 15 & 16 *supra*. Since the SEC derives its injunctive powers from statute, the SEC need not establish irreparable harm and absence of an adequate remedy at law as required of private plaintiffs in private injunctive actions. *See* SEC v. Torr, 87 F.2d 446, 450 (2d Cir. 1937). The Commission must establish, however, the elements of the authorizing statute. *See* 446 U.S. at 700-01; SEC v. World Radio Mission, Inc., 544 F.2d 535, 541 (1st Cir. 1976).

[138] *See* SEC v. World Radio Mission, Inc., 544 F.2d 535, 541 (1st Cir. 1976); SEC v. Management Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975). Evidence of past violations, without proof that such conduct is likely to recur, will not meet prerequisites to an SEC in-

prerequisites to injunctive relief, the *Aaron* Court noted that the presence or absence of scienter in a defendant's past misconduct has a significant bearing on a court's determination of whether the defendant will commit future violations.[139] In his concurring opinion in *Aaron*, Chief Justice Burger observed further that to show a reasonable likelihood of a future violation, the SEC almost always will have to demonstrate that a defendant's past conduct resulted from more than negligence.[140] The Chief Justice noted that courts are not likely to enjoin a defendant whose past actions have been in good faith.[141] Since an isolated and uncharacteristic act of negligence may not provide an adequate basis for determining the reasonable likelihood of future misconduct, a scienter requirement exists implicitly in all SEC injunctive actions regardless of whether the language of a substantive provision connotes scienter.

Although courts are reluctant to enjoin a fraudulent practice arising out of a single negligent act, a defendant may not participate in fraudulent acts indefinitely. Courts that recognize scienter to include knowing or reckless misconduct may hold that once the defendant receives notice from the SEC or an interested party that his fraudulent acts have deceptive effects, the continuation of these acts establishes scienter.[142] Thus, the actual effect of a scienter requirement on negligent practices may be only to delay a Commission injunctive proceeding until the defendant receives notice and fails to take steps to prevent the practices from continuing in the future.[143]

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junction. *See* SEC v. World Radio Mission, Inc., 544 F.2d at 541. Courts suggest, however, that evidence of a past violation raises an inference of future violations. *See* SEC v. Koracorp Indus., Inc., 575 F.2d 692, 698 (9th Cir. 1978); SEC v. Management Dynamics, Inc., 417 F. Supp. 1225, 1248-49 (E.D.N.Y. 1976), *aff'd*, 556 F.2d 559 (2d Cir.), *cert. denied*, 434 U.S. 855 (1977).

[139] *See* text accompanying note 56 *supra*.

[140] 446 U.S. at 703 (Burger, C.J., concurring).

[141] *Id.*; *see* text accompanying note 136 *supra*.

[142] *See* SEC v. Aaron, No. 77-6091 (2d Cir. Jan. 27, 1981) (defendant's failure to prevent fraudulent practices from continuing after receiving notice of practice establishes his scienter). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 886 (2d Cir. 1968) (en banc) (Moore, J., dissenting) (noting that repeated violations lead to inference of purposeful conduct). By analogy, the Federal Trade Commission Act, 15 U.S.C. § 45(m) (1976) provides statutory authority for the principle that continuing failure to correct conduct that is unfair or deceptive following notice may constitute a violation sufficient to impose an injunction or civil penalty upon the actor. *See* 15 U.S.C. § 45m(1)(c) (1976) (continuing failure to comply with Federal Trade Commission cease and desist order constitutes a separate violation for each day deceptive practices continue).

[143] The defendant may receive notice from an interested party. *See* 446 U.S. at 683 (issuing corporation's attorney notifying defendant of misrepresentations). The SEC also may contact a defendant and inform him of his deceptive conduct. *See* BLOOMENTHAL, *supra* note 13, at § 8.02[1]. The SEC may warn the party to cease any deceptive conduct. *Id.* This caution to the party, often called an "office injunction," provides the SEC an opportunity to seek a voluntary consent decree from the party that he will discontinue his practices without the SEC resorting to a federal district court for an injunctive order. *Id.*

The Supreme Court's determination in *Aaron v. SEC* that scienter is an element of proof in SEC injunctive actions under section 17(a)(1), section 10(b), and rule 10b-5 of the securities laws resolves a controversy that has long divided the federal courts.[144] Although the SEC must now prove scienter whenever scienter is an express element of a violation that the SEC seeks to enjoin,[145] this requirement should not have a significant impact on the SEC civil enforcement process.[146] Several courts previously have recognized scienter as an implicit element in SEC injunctive actions.[147] Moreover, the Supreme Court's decision does not place all negligent actions beyond the scope of the SEC's injunctive powers. Repeated negligent violations of the securities laws may constitute culpable behavior sufficient to establish scienter.[148] The negligent acts of sellers of securities also remain enjoinable despite a scienter requirement under section 17(a)(1) and section 10(b), since scienter is not an element of violations of sections 17(a)(2) and 17(a)(3).[149]

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[144] 446 U.S. at 701-02; text accompanying note 6 *supra.*

[145] *See* 446 U.S. at 701.

[146] *See id.* at 703 (Burger, C.J., concurring) (scienter issue in injunctive actions is "much ado about nothing"); text accompanying notes 133-143 *supra.*

[147] *See* text accompanying note 136 *supra.*

[148] *See* text accompanying notes 142-143 *supra.*

[149] *See* text accompanying note 79 *supra.*