



Washington and Lee University School of Law  
Washington and Lee University School of Law Scholarly Commons

---

Supreme Court Case Files

Lewis F. Powell Jr. Papers

---

10-1975

## Ernst & Ernst v. Hochfelder

Lewis F. Powell Jr.

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/casefiles>

 Part of the [Administrative Law Commons](#), [Courts Commons](#), and the [Criminal Law Commons](#)

---

### Recommended Citation

*Ernst & Ernst v. Hochfelder*. Supreme Court Case Files Collection. Box 30. Powell Papers. Lewis F. Powell Jr. Archives, Washington & Lee University School of Law, Virginia.

This Manuscript Collection is brought to you for free and open access by the Lewis F. Powell Jr. Papers at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Supreme Court Case Files by an authorized administrator of Washington and Lee University School of Law Scholarly Commons. For more information, please contact [christensena@wlu.edu](mailto:christensena@wlu.edu).

I think that the question whether a private 10b-5 action can be maintained for simple negligence is an important question that merits consideration now. I don't see that a trial will really add anything to the Court's understanding. (That is question #1 in the petition).

The statute of limitations question likewise is ready for decision now and probably sufficiently important to be c/w. The only fear is that the Court might avoid the 10b-5 question by deciding that issue. If you want the 10b-5 issue, and you want to avoid any possibility of not reaching that issue I would recommend passing the s/l question (question # 2 in petition) and limiting the grant to question #1.

*Respondent's Answer: Says its not ripe for review & that conflict is exaggerated. The conflict seems to be real to me however, at least insofar as the articulation of the "flexible std" is concerned.*

April 11, 1975 Conference  
List 1, Sheet 3  
No. 74-1042

ERNST & ERNST

v.

HOCHFELDER, et al.

ERNST & ERNST

v.

MARTIN, et al.

Petitioner, an accounting firm, seeks review of the court of appeals reversal of a district court's grant of a motion for summary judgment in a 10b-5 action. Respondents assert that petitioner's failure to comply with local Seventh

*in this case?*

*(10b-5 issue)*

*DISCUSS*

*CA 7 upheld a 10(b)5 cause of action vs Ernst & Ernst based solely on alleged negligence in not following accepted accounting practices over a period of many years as auditor of a small brokerage firm which defrauded Respondents.*

PRELIMINARY MEMORANDUM

Cert CA 7

*There is a sharp split on this issue.*  
(Swygert, Castle, Sprecher)

*I'd grant, limited to 10(b)5 issue.*  
Federal/Civil

*5/line. issue is also imp. but we'd not reach 10(b)5 issue if*  
Timely

*we reversed on 5/line*

*Grant Q#1*  
*DB*



Circuit rules and notify the lower courts of the intention to seek certiorari at this stage has resulted in the district court's moving forward with the action, and that certiorari should be denied for that and other reasons.

Facts: The essence of respondents' claim as plaintiffs in the 10b-5 litigation is that petitioner's failure adequately to audit a small brokerage firm's accounts and practices over the 21 years in which it was employed by the firm allowed the president of the company to perpetuate a fraud against them. Respondents asserted that proper auditing would have uncovered the fraud that caused the loss. The action stems from the activities of Mr. Nay, President of First Securities Company of Chicago and owner of 92% of its stock. Respondents were brokerage clients of First Securities, and each received investment counseling from Nay knowing him to be president. Nay persuaded each to invest funds in a fraudulent "escrow" account which he represented would produce a high rate of return. Some respondents began to invest as early as 1942, and the last of the escrow transactions was consummated in 1966. The whole scheme fell apart when Nay committed suicide and left a note describing his misdeeds.

As a result of the scheme, the Seventh Circuit held that Nay had violated the Securities Exchange Act and that First Securities was chargeable with Nay's fraud as an aider and abettor.



Securities & Exchange Commission v. First Securities Co. of Chicago, 463 F. 2d 981 (1972). With Nay gone and First Securities in receivership, however, these respondents have looked for another pocket of adequate depth to satiate their financial wounds. Ernst & Ernst, an accounting firm that had audited First Securities for some 21 years without ever discovering the fraud, was selected.

The action was predicated on the theory that the negligent auditing of Ernst & Ernst aided and abetted Nay's 10b-5 violation. Respondents, plaintiffs below, contend that had Ernst & Ernst properly audited First Securities the fraud would long ago have been uncovered. The District Court ruled in Ernst & Ernst's favor on a motion for summary judgment, finding that the statute of limitations had run and apparently determining that petitioners were additionally entitled to a judgment as a matter of law. The court of appeals reversed this ruling and remanded for trial in accordance with the rather elaborate theories of law that it outlined.

7, Relying on its previous ruling in Hochfelder v. Midwest Stock Exchange, 503 F. 2d 364 (CA 7 1974), cert denied 419 U.S. 875 (Douglas, J., dissenting)[See pool memo in 73-1828] the Court found that the statute of limitations had been tolled against the negligent party, petitioner herein, by fraudulent actions of Nay. The court thereafter found a statutory duty of inquiry imposed by the Securities Act that ran to respondents'



benefit. The court defined that duty to be one to audit in accordance with the generally accepted auditing standards and looked to the definitions of The American Institute of Certified Public Accountants to ascertain that standard. The court determined that factual issues existed concerning petitioner's compliance with those standards and also ruled that factual questions were presented relating to a theory of estoppel that might preclude respondents' recovery. It remanded for trial on those issues.

Contentions: Petitioner's contentions will be discussed separately and not in the order in which they are presented in the petition. Anyone wishing to suggest a limited grant must be careful to identify the questions in the order they are presented in the petition rather than in the order of discussion in this memo.

1. Statute of Limitations (Question # 2 in petition)  
Petitioner challenges the court of appeals' determination that the three-year statute of limitations would be tolled against it, an allegedly negligent party, on account of the fraudulent actions of Nay, who was not a party to the litigation. The court relied on its previous ruling in Hochfelder to hold that the tolling doctrine is an equitable one with sufficient flexibility to reach this case. The court held in each case that the tolling doctrine would toll the statute of limitations against a party whose alleged negligence was asserted to have



facilitated the concealment of the fraud that caused the injury. As in the case of an action against the party who perpetrated the fraud, the statute would be tolled against one whose alleged negligence facilitated its concealment until such time as the plaintiff obtained knowledge of the fraud or in the exercise of due diligence should have obtained such knowledge.

Petitioner claims that this extension of the tolling doctrine is unique to this case and to Hochfelder, and that it is in direct conflict with the Fifth Circuit opinion in Cato v. Southern Atlantic & Gulf Coast Dist. of Int'l. Longshoremen's Ass'n., 364 F. Supp. 489 (S.D. Tex. 1973), aff'd. sub nom, Cato v. International Longshoremen's Ass'n., 485 F. 2d 583. In that case the statute of limitations was asserted by the defendant employer who was being sued under the Railway Labor Act. Plaintiff there argued that the statute should be tolled as to defendant employer by the misrepresentations of certain co-defendant union representatives. The District Court specifically refused to allow the misrepresentations of one defendant to toll the statute of limitations as to another, 364 F. Supp., at 493, and the CA 5 per curiam affirmance specifically mentioned its agreement with that ruling. 485 F. 2d, at 583. Petitioner additionally asserts that the ruling in this case is contrary to the general characterizations of the doctrine of fraudulent concealment, which points to



fraud perpetrated by the person against whom the statute is tolled. See Detroit v. Grinnell Corp., 495 F. 2d 448, 460 (CA 2 1974). Petitioner additionally urges that the CA 7 rationale is contrary to the basic premise of the statute of limitations, which is fairness to defendants. See Burnett v. New York Central R.R. Co., 380 U.S. 424, 428 (1965).

2. Scienter Requirement under 10b-5 (Question # 1 in petition) Petitioner challenges the assumption of CA 7 that a 10b-5 action can ever be maintained in the absence of allegations of facts amounting to intent to defraud, reckless disregard for the truth, or knowing use of a device to defraud. Petitioner asserts that an allegation that merely charges negligence, as this one does, cannot be maintained under 10b-5. CA 7 relied on its previous ruling in Hochfelder, which it said indirectly decided the issue. The court held that a 10b-5 cause of action could be satisfied by a showing of the following elements:

"The foregoing elements comprise a flexible standard of liability which should be amplified according to the peculiarities of each case. Accordingly, where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating; (1) that the defendant has a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention."



Petitioner claims that CA 7's negligence standard is in direct conflict with rulings of the Second, Sixth, and Tenth Circuits. See Lanza v. Drexel & Co., 479 F. 2d 1277, 1302-1305 (CA 2 en banc 1973); Clegg v. Conk, \_\_\_ F. 2d \_\_\_, 1973-74 CCH Fed. Sec. L. Rep. ¶ 94,897 (CA 10 1974). Petitioner notes, on the other hand, that dicta in the Eighth and Ninth Circuits suggest that those courts of appeal may fall in line with the decision he seeks to have reviewed. See Myzel v. Fields, 386 F. 2d 718, 734-735 (CA 8 1968), cert. denied, 390 U.S. 591; Vanderbloom v. Sexton, 422 F. 2d 1233, 1239 (CA 8 ), cert. denied, 400 U.S. 852 (1970); White v. Abrams, 495 F. 2d 724, 736 (CA 9 1974). Petitioner asserts that this issue is one of substantial consequence to the determination of the permissible reach of Section 10b-5.

3. Defense of Estoppel - (Question # 3 in petition).

Petitioner seeks to have the Court review the question of whether he was entitled to a judgment as a matter of law on the estoppel issue. The facts of the case indicate that petitioners mailed some of the respondent plaintiffs confirmation forms, requesting that they as customers of First Security verify the accuracy of the details of their accounts, and moreover, expressly requesting that the customers note any differences or exceptions between the accounts specified on the form and the actual account that the customer maintained. Petitioners indicate that none of the respondents who received the confirmation form notified them of the unlisted escrow account and that the lower court erred



in not ruling that this failure estopped them as a matter of law.

The court of appeals indicated that any number of factual contexts might arise in which the affirmative defense of estoppel might not properly be asserted. It stated, for example, that the plaintiffs failure to report the unlisted escrow account might not be unreasonable if a reasonable investor should not have known from the confirmation form that he was to report the escrow account. This was, in the view of the court of appeals, a factual question that should be resolved by the jury.

4. Exercise of Due Dilligence (Question # 4 in petition)  
Petitioners claim that they were entitled <sup>to</sup> a judgment as a matter of law on the question of their exercise of due diligence. They claim to have satisfied the generally accepted accounting standards in auditing this account; they thus assert that they could not be found to be negligent.

The court of appeals relied on the standards of the American Institute of Certified Public Accountants, of which petitioners are members, for the proposition that responsible auditing procedures should encompass some check on the audited firm's system of internal accounting controls. The court of appeals observed that a factual issue seemed to exist over whether adherence to such an auditing procedure might not



have discovered Mr. Nay's "mail rule,"<sup>1</sup> and thus altered a responsible accountant to the possibility that something was amiss in the company. Petitioners maintain essentially that the accounting rules referring to monitoring of internal accounting mechanisms are not designed to detect such fraud. The court of appeals considered that to be a factual question.

Respondent's Late Filing Argument - Respondent does not really contest petitioner's characterization of the possible significance of the issues or of the existence of a lower court split as to some of them. Respondent does, however, assert that the important questions would be further illuminated by allowing the trial to go forth and taking the questions later. Respondent notes in this regard that the Local Rules of the Sixth Circuit indicate that a mandate will not be stayed to await filing of a petition for certiorari absent a showing that there is probable cause to believe that petition is not frivolous or filed for delay. He claims that petitioners waited until the 90th day to file for certiorari in this case and that they failed to notify the court of appeals of their intention to file.

---

1. The "mail rule" was a firm rule laid down by President Nay that ~~there~~<sup>no one</sup> was to open correspondence addressed to him personally, or to his attention. Nay apparently insisted that his mail was not even to be opened in cases in which he would be away from the office for a substantial period of time.



Respondent asserts that, as a result, the mandate has long since issued and the case is pending for trial before the District Court.

Discussion: Respondent's reliance on the Local Rule appears to be a makeweight; surely the case has not advanced significantly toward trial during the period required for filing and consideration of cert. His claim that the issues would benefit from trial on the merits seems better taken in the case of the questions of estoppel and the petitioners' satisfaction of the due diligence standard. Those are more fact-specific and, in any event, do not appear to be the more significant issues presented by the petition.

Both the statute of limitations question and the question of liability for negligence under 10b-5 were previously decided in Hochfelder, on which the Court recently denied certiorari. But the pool memo on the case reveals that neither of those issues was presented in that petition for certiorari. Petitioners' claim of the existence of a split on these issues appears to be correct.

Anyone interested in this case might seek the views of the Solicitor General. He recently sought certiorari to urge a negligence standard for SEC injunctive actions under Section 10b. See SEC v. Coffey, 493 F. 2d 1304, 1316-1317, pool memo 74-661, denied January 27, 1975.

There is a response.

March 26, 1975

Boyd

CA op in app.

But  
SG has  
now  
proposed  
a new  
standard.  
See SG's Brief  
in this



ERNST & ERNST, Petitioner

VR.

OLGA HOCHFELDER, ET AL.

2/20/75 Cert. filed.

Grant

[illegible]



LFP/vsl  
August 21, 1975

No. 74-1042, Ernst & Ernst v. Hochfelder, et al

The purpose of this memo, dictated during the summer, is to aid my memory as to the issues presented, and to record my quite tentative reaction after a preliminary reading of the opinions and briefs.

\* \* \* \* \*

Leston B. Nay ("Nay"), president of a small brokerage firm in Chicago, committed suicide after perpetrating frauds upon respondents and other customers of the firm over a period of many years. The frauds were accomplished through "escrow" investment accounts which Nay personally managed, and from which he misappropriated customer funds. His company, First Securities, was registered with the SEC as a broker-dealer, and was a member of the NASD.

Following Nay's suicide, the SEC initiated receivership proceedings, and various claimants -- including these respondents -- prosecuted claims against First Securities which were duly allowed. See SEC v. First Securities Co., 463 F.2d 981 (CA7, 1972), cert. denied, 409 U.S. 880.

The present litigation was instituted on February 19, 1971 (Nay's suicide having occurred in June 1968), by respondents



against the accounting firm of Ernst & Ernst, petitioner here ("Ernst").\* The sole basis for federal jurisdiction was an alleged violation of Section 10(b) of the Act of 1934 and Rule 10b-5 thereunder, the complaint alleging that Ernst "aided and abetted" in the fraud perpetrated by Nay.

The complaint does not allege that Ernst committed, or had knowledge of, any fraud; <sup>A 81</sup> nor does it charge Ernst with reckless or willful conduct <sup>A 86</sup> (see A. 81, 85-86; see also amended complaint). Rather, the substance of the complaint is that Ernst negligently failed to exercise proper care in its auditing procedures, and particularly that it failed to comply with generally accepted accounting standards.\*\*

The case was submitted on motion for summary judgment, supported by affidavits and depositions. The charge of negligence focused on the failure of Ernst to make an adequate inquiry into the way in which Nay personally handled the escrow accounts. It appears that Nay imposed a rule within his firm to the effect that only he could open mail addressed to him or to the firm

---

\* The first count in this suit was against the Midwest Stock Exchange, and is not here involved.

\*\* The term "negligence" is not used in the complaint, but -- absent fraud or reckless conduct -- there is no other basis for the liability asserted.



("Nay's Mail Rule"). The escrow accounts were not reflected on the books of the company. Upon his death, a substantial volume of correspondence was discovered that related to the escrow accounts. The essence of respondents' claim for damages is that if Ernst had properly discharged its duty as auditor, it would have investigated the way in which mail was handled within the firm and would have discovered Nay's mail rule.

#### Decisions of the Courts Below

The DC granted Ernst's motion for summary judgment, but this was reversed by CA7 in a long and rambling discourse (reading more like a second rate law review comment than a court opinion) that is somewhat less than illuminating. CA7 held that a proper case had been alleged under Section 10(b) and Rule 10b-5.

It was conceded that no actual knowledge of fraud was averred, and that scienter was not charged by respondents. In effect, CA7 inferred knowledge of fraud (assuming the allegations to be true) on the theory that if Ernst had exercised due diligence (i.e., had not breached an alleged duty to inquire into Nay's mail rule) it would have discovered and disclosed the fraud. In short, under the rationale of CA7's opinion, proof of negligence on Ernst's part in failing to discover Nay's mail rule would subject Ernst to damage liability under the Securities Act.



CA7 thereupon concluded that summary judgment was improper; that there were genuine issues of material fact to be decided at trial; and the case was remanded for trial.\*

Although the case at this time is in an "interlocutory" status in view of the remand for trial, we granted cert for the purpose of considering the applicable standard of liability in a damage suit under Section 10(b) and Rule 10b-5. There is a conflict among the circuits, although the negligence standard adopted by CA7 is the minority view.

#### The Question

The questions which, as I am presently advised, need to be considered by this Court are best expressed in the amicus brief on behalf of the American Institute of CPAs:

1. May liability for damages be imposed upon accountants pursuant to Section 10(b) of the 1934 Act and Rule 10b-5 for negligent failure to comply with generally accepted auditing standards in the absence of pleading and proof of scienter?
2. May an auditor be liable in damages for aiding and abetting his client's violation of Section 10(b) of the 1934 Act and Rule 10b-5 in the absence of knowledge of the client's violative conduct and solely on the basis of negligent performance of audit functions?

---

\* Other issues are involved in this case, including equitable estoppel and the applicable statute of limitations. As I presently view the case, these issues need not be reached.



The issue posed by these related questions is important. As we had occasion recently to note in Blue Chip Stamps v. Manor Drug Stores, private causes of action for damages under Section 10(b) and Rule 10b-5 have evolved expansively by judicial interpretation. The decision of CA7, if affirmed by us, would advance this process to new frontiers. Damage liability could be imposed for negligence not only upon the contracting party (the brokerage firm in this case), but also upon a "third party" accounting firm.

#### The Relevant Statutory and Rule Language

Section 10(b) of the Act of 1934 makes it unlawful:

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

If the "plain meaning" rule is applied, we need go no further than the foregoing statutory language. The proscribed conduct, applicable "in connection with the purchase or sale of any" security, is identified as "any manipulative or deceptive device or contrivance in contravention" of rules and regulations of the Commission. This language has been held by most circuits addressing the problem as requiring "scienter," usually defined



as actual knowledge of or reckless disregard of fraudulent conduct.

Rule 10b-5, adopted pursuant to Section 10(b), am- See A 86  
plifies the language of the statute. It is unlawful under Sub-  
section (1) of the Rule "to employ any device, scheme or arti-  
fice" to defraud; under Subsection (2) "to make any untrue state-  
ment of a material fact or to omit to state a material fact nec-  
essary to make the statements" not misleading; and under Subsec-  
tion (3) to engage "in any act, practice, or course of business  
which operates or would operate as a fraud or deceit upon any  
person" -- in each of these situations in connection with the  
purchase or sale of any security.

*It's  
only  
on  
this  
only*

Subsection (2) does not expressly contain the words  
"defraud," "fraud" or "deceit;" nor does it refer to any "manipu-  
lative or deceptive device." But the Rule must be construed in  
light of, and consistently with, Section 10(b). Indeed, if the  
Rule were construed to create a liability based upon simple neg-  
ligence, petitioner argues with logic that the Rule would be in-  
valid as imposing a standard significantly more exacting than  
that required by the statute itself.

#### Legislative and Regulatory History

The briefs of petitioner and amicus make a rather



persuasive case to the effect that such legislative history as exists also supports the requirement of scienter. See p. 39 et seq. of petitioner's brief; and p. 13 et seq. of the amicus brief of the American Institute of CPAs.

#### Decisions of Courts of Appeals

The briefs assert that decisions in CA2, CA5, CA6, and CA10 construe 10(b) and Rule 10b-5 as requiring scienter (i.e., a degree of culpability beyond negligence). I have examined only a couple of CA2 decisions, and these do support generally this position: see, e.g., Judge Friendly's concurring opinion in SEC v. Texas Gulf Sulfur, 401 F.2d 833, which has since been followed in that circuit; and Shemtob v. Sherson, Hammill and Co., 448 F.2d 442, 445.

Apparently CA9 (White v. Abrams, 495 F.2d 724) is generally in accord with CA7.

Petitioner's brief cites Professor Loss and other secondary authorities in support of its position.

#### Policy Considerations

In Blue Chip Stamps, we gave weight to "policy considerations." I am inclined to agree that such considerations are especially relevant where we are asked to extend by judicial



interpretation civil liability for damages under a statute which, by its terms, imposes no such liability. As in Blue Chip Stamps, a negligence standard applicable to auditors would invite litigation based on a simple averment of absence of due care, not merely in the recording of the facts as reflected by the company's books but in failing properly to discover mismanagement or fraud. Third party suits of this kind, brought years after the occurrences of the alleged negligence and viewed with "hind-sight" vision, would impose a high risk of liability on accountants.

Comment

But quite apart from other considerations, I find no basis in the statute -- or indeed in the Rule -- for the negligence standard applied by CA7. After all, the respondents elected to sue in the federal court and jurisdiction is asserted under Section 10(b). This has been viewed from the outset as a "fraud" statute.

Although my present disposition is evident from this memorandum, this is a case with potentially wide ramifications. I will try to keep a reasonably open mind pending further study and discussion, and the oral argument.

L. F. O.



December 1, 1975

To: Justice Powell

From: Greg Palm

No. 74-1042 Ernst & Ernst v. Hoechfelder

After studying this case fairly carefully this past summer I discovered that my own conclusions regarding the advisability of adopting a negligence standard for rule 10b-5 liability were similar to your own(as expressed in your "aid-to-memory" memorandum)--ie. the language of the ~~statute~~ and legislative history(admittedly almost none), if anything, point ~~away~~ from the conclusion that any type of negligence standard was intended; <sup>①</sup> the structure of the Securities Acts--ie. there are places where a type of negligence standard has expressly been created, such as the duty of experts in the case of registration statements( defense of due diligence)--supports the conclusion that something more <sup>②</sup> than mere negligence was intended; finally, the policy arguments identified in petitioner's brief--many of which are derived from Blue Chip Stamps--and noted by you in your memorandum also support the view that some type of quasi-scienter standard is appropriate.



The "weight" of judicial authority--ie. Judge Friendly in Texas  
Gulf, Judge Adams .....--also supports this position.

In light of this agreement I decided at that time that it would not be very fruitful to write a memorandum unless and until I thought of some important factors that would argue against the conclusion reached in your own preliminary memorandum. As yet I have thought of none. Thus, although I intend to review the briefs tomorrow so that they will be fresh in mind should you want to discuss the case prior to voting on friday, I intend to give you no memorandum in this case.







## Berner (for Ernst & Ernst)

I rule in whether 10b & 10b-5 are to be turned into a national negligence standard.

Alleged negligence:

1. Hay's Rule as to mail.
2. " took no reg. vacations.

First case sustaining damages for "negligently" "aiding & abetting" a fraud. No other securities law case has gone so far.

Relies on language of 10b - ~~is~~ is language of fraud, not negligence.

Leg. hist. not explicit - but hist. is clear that "honesty" or "dishonesty" was concern of Congress, not negligence.

Majority of Circuits (on level of culpability) require more than negligence



Berner

No reason for a remand. The Record already contains all facts pertaining to E & E's conduct

It's now over "willful" misconduct - but complaint makes no such claim, & CA 7 expressly found no willful misconduct or fraud, & not even a basis for common law liability.

(Rehuguen + - SEC, as ~~an~~ amicus, has no standing to raise a new theory)



King (for Resper)

(Nothing in her argument  
that helps)

LaSerna (for Resper)

Read  
White's  
comments

Relies on 17(a) - but I White  
& I both quest. whether Resper  
may now rely on 17(a).

CAT did not decide any 17(a)  
issue.

Gouson (Associate Counsel for SEC)

(not fraud)

Assuming reg. to be basis of  
this complaint, ~~the~~ case should be  
dismissed. (See SEC Brief).

Read  
Transcript  
of  
his  
statement.

(Stewart asked about 17(a). Gouson  
noted that CAT did not ~~and~~ rule on  
17(a). Speaking generally, 17(a) relates  
to audit of broker-dealers - & SEC  
has taken no position on liability  
under 17(a).



Gonzon (for SEC)

Neg. ~~may~~ may justly demand  
under 10 b-5. Conceder leg.  
his, is not supportive of this view.

(See Stewart's comment on  
meaning of language of 10 b -

Gonzon argues that language  
at least ~~is~~ is ambiguous. Should  
interpret broadly.

White notes we are dealing  
with a section providing for  
no relief, & <sup>the</sup> only relief has  
been implied. Under some

~~Under~~ sections of Acts,  
negligence is not enough  
— indicating Congressional  
judgment that all violations  
should not ~~be~~ result in liab.  
for negligence. Why therefore  
should ambiguous language  
be broadened beyond these  
provisions ~~of~~ Act.  
(see over)

Imp.  
series  
of  
questions  
by  
White





Office of the Solicitor General

Washington, D.C. 20530

December 4, 1975

RECEIVED

DEC 4 1975

OFFICE OF THE CLERK  
SUPREME COURT, U.S.

*file*

Honorable Michael Rodak, Jr.  
Clerk  
Supreme Court of the United States  
Washington, D.C. 20543

Re: Ernst & Ernst v. Hochfelder  
(No. 74-1042)

Dear Mr. Rodak:

During the argument yesterday in the above case, Mr. Justice Brennan asked government counsel what was the position of the Securities and Exchange Commission on whether an implied right of action exists under Section 17(a). Counsel responded that the Commission had taken no position on that question. Counsel assumed that the question referred to Section 17(a) of the Securities Exchange Act of 1934, which requires that brokers and dealers maintain certain records pertaining to their financial condition and submit reports to the Commission.

Because of a prior colloquy between Mr. Justice Blackmun and one of the counsel for respondents, government counsel is concerned that Mr. Justice Brennan might have been referring to Section 17(a) of the Securities Exchange Act of 1933, which is an antifraud provision. The Commission has taken the position that an implied right of action exists for violation of the latter provision.

Would you please distribute copies of this letter to the Court.

Sincerely,

*Robert H. Bork*

Robert H. Bork  
Solicitor General





cc: Kenneth J. Bialkin, Esq.  
Louis A. Craco, Esq.  
1 Chase Manhattan Plaza  
New York, N.Y. 10005

Francis D. Morrissey, Esq.  
130 East Randolph Drive  
Chicago, Illinois 60601

Willard L. King, Esq.  
King, Robin, Gale & Pillinger  
135 South LaSalle Street  
Chicago, Illinois 60603

Willard J. Lassers, Esq.  
Elson, Lassers and Wolff  
11 South LaSalle Street  
Chicago, Illinois 60603

Donald L. Vetter, Esq.  
135 South LaSalle Street  
Chicago, Illinois 60603

Leon M. Despres, Esq.  
77 West Washington Street  
Chicago, Illinois 60602



Claim is that Petitioner  
"aided & abetted" Nay's fraud.  
SEC Brief not helpful. It  
says if Reiser had brought  
a different case they might  
have cause of action.

10(b) language does not  
suggest negligence.

See no violation of Act  
or of 10 b.5.

Not in these any genuine  
issue of fact.

Brennan, J. Affirm

SEC's submission is  
appealing. Whenever SEC  
sues under 10 b.5, we  
2.7 & other courts have applied  
a negligence doctrine.

Neg. standard is well  
within language of both  
10 b & 10 b.5. But SEC  
then goes on to identify  
those facts that must be  
shown - none of which is  
shown on this record. SEC  
goes too far in redefining  
requirements of negligence.

Stewart, J. Reverse

Language of 10 b (derived  
from verbs manipulate &  
deceive) is not language of  
negligence. 10 b.5 can  
be read to include absolute  
liability as well as  
negligence, but this is  
unauthorized by statute.

This is a damage suit.  
~~to~~ An injunction ~~of~~  
sued by SEC might  
~~be~~ present dif. case



## Reverse

SEC anxious to have right to enjoin neg. conduct under 10b + 10b-5, because language would normally be applied same way to injunction as well as to private damage suit.

But 10b can't fairly be read so broadly.

This would open up broad area of private liability: 10b-5(2) is not authorized by statute.

## Powell, J. Reverse

The Complaint (& answers to Interrogatories) expressly disclaim any fraud or reckless or willful conduct (A81,86).

Altho. "negligence" is not averred in terms, this is the gist of the action and of CA's opinion.

It is conceded there would be no common law liability as there was (i) no privity, & (ii) no reliance.

10(b), by its terms, applies only to "any manipulative or deceptive device or contrivance". This is not the language of negligence.

Other provisions of Act make plain that Congress knew how to distinguish between liability for negligence and for a higher standard (i.e. liability of issuer (absolute) with that of an expert (disclaimer)).

## Reverse

Agrees with Stewart

## Blackmun, J. Affirm

Agrees with Brennan

## Rehnquist, J. Reverse

## Powell (continued)

In Blue Chips, we noted that liability under 10(b) was judiciously created & should not be extended beyond clear purport of Act.

Majority of CA cases (including CA2 - Incredibly in Taxon Galt Sweeney) decline to read a negligence standard into Act. Scienter is required.



# Outline of Greg's Draft

## I.

Facts - 1 - 9

Hest of litigation - 3 (not clear as to 2 suits) - 5

## II.

General - purpose of Acts - 6

10(b) & 10(b) 5 - 6, 7, 8

Implied cause of action - 9

Views differ whether scienter is a required element - 9, 10.

## A.

Statutory language (plain language)

One H on "plain language" - 10

SEC's contention - effect oriented - 10, 11

SEC further contends that Congress said "unlawful" when it meant to - 12, 13.  
(citing § 9 - manipulation of prices)

Greg answers (p 13) by saying whenever express civil liability was imposed, it did so in clear terms. Citing 1933 act §§ 11, 12, 15; & '34 Act §§ 9, 16, 18 & 20 (p 13)

may not be strong enough before moving to SEC's argument



## II A (cont.)

Resps. adapt SEC's position,  
and make a further argument  
as to "remedial purposes" - 14, 15  
(See my Rider A 14)

Transition to Leg. Hist - 15, 16.

## B.

Leg. History - 16 -

## C.

33 & 34 Acts are interrelated  
components of regulatory scheme. - 24

Act of 34 - each express  
liability provision (except 16 b)  
contains a "state of mind" requirement.  
E.g. § 9, 18 & § 20 (p 25, 26)

Act of 33 - no state of mind  
requirement in §§ 11, 12(2) but each  
is limited by restrictions on  
venue & costs & short S/Lwr. - 26, 27

## Effect of 1934 Amendments

a negligence rule would nullify  
restrictions on private damage suits  
by purchasers specified in 33 & 34 acts - 28

Why?  
Would  
all suits  
be under  
10(b)?



D

Subsection 2 of 10 b 5



MEMORANDUM

TO: Greg Palm  
FROM: Lewis F. Powell, Jr.

DATE: February 4, 1976

74-1042

Ernst & Ernst

You were quite right in saying that this is not an easy case to write. I have no difficulty with the correctness of our basic analysis, but nevertheless find it a difficult and delicate task to put an opinion together that satisfies.

[?]

No substantive  
changes whatsoever

I return herewith your draft of 1/16/76. In view of the number of changes made, and to facilitate your further editing, Sally has prepared a partially "cleaned up" copy reflecting my editing. I give this to you, together with your original draft from which you will be able to see exactly what I have done.

I have adhered to the basic structure of your draft. Nor was I able to reduce the length appreciably, and possibly not at all.

As I have devoted all the time now available to me on this case (with others backed up awaiting my attention), I would appreciate your resuming the editing and revising process. In undertaking this, in addition to the changes I have made and my marginal suggestions, I have the following thoughts:



1. The contrast you have drawn throughout the opinion is between "knowing or intentional misconduct", on the one hand, and negligence or "negligent misfeasance", on the other. What is the derivation of this terminology? The briefs and arguments, for the most part, spoke simply in terms of "scienter" and "negligence". Judge Adams in Korn (at p. 287) used language that I like:

"An intent to deceive, manipulate or defraud."

Adams, p. 285, also referred to Judge Friendly's formulation as including "recklessness" that amounts to fraud. What would you think of our using the term "scienter" and defining it early in the opinion, using the Adams/Friendly terminology? Also, is there a reason for use of the term "misfeasance" in conjunction with "negligence"? In connection with choice of terminology, 10(b) uses "deceptive device or contrivance" and Rule 10b-5, in two of its subsections uses the term "fraud".

2. I notice that Adams opinion in Kohn, in quoting the Rule, includes its caption: "Employment of Manipulative and Deceptive Devices". In the briefs, however, I recall no reference to this caption. If, indeed, the published rule includes the caption, we should make some reference to it in III-D where we address the meaning of subsection (2).

I already  
use this in  
Part I.



3. I am under the impression that there is a good bit of repetition in our references to the sections of the two Acts providing for "express" liability. We rely on these sections in several different places in the opinion. This is probably desirable, but you might keep this in mind in the editing process.

But  
privity - fraud  
only but not both

4. We do not discuss the absence of "privity" in the common law sense between Ernst & Ernst and respondents. I view this as an important fact, and indeed one that could be controlling with me. We took the case, however, to resolve the conflict as to scienter, and I do not think a majority of the Court would be willing to dispose of it on the absence of privity. We should address this question in a footnote. I would welcome your thought as to what should be said.

5. You have indicated to me the reason for not including a discussion of "policy considerations". I was impressed, however, with Judge Friendly's discussion of such considerations in his concurring opinion in Texas Gulf Sulphur. He was there focusing on the effect of a mere negligence rule on management of corporations in determining what information to disclose to stockholders. I agree with Judge Friendly that a serious policy consideration is present in that context. I wonder, also, whether a similar - or perhaps even more serious - policy consideration is not present in a case like this one where liability is sought to be imposed upon an accountant



in the absence of privity, and also in the absence of any reliance by the plaintiffs on what the accountant did. You might try your hand at a footnote summarizing generally the relevant policy considerations, noting that we need not elaborate on these in view of the language and history of 10(b).



MEMORANDUM

TO: Greg Palm  
FROM: Lewis F. Powell, Jr.

DATE: February 18, 1976

74-1042  
Ernst & Ernst

We must do something with footnote 20. Apart from its unacceptable length (as a single note), it overdignifies some rather far-fetched argument (really "grasping at straws") advanced in this case.

As to reliance on Cochran's reference to "negligence", I would dispose of that quite summarily by saying that taken, in context, it was a general observation made in a discussion of § 8 that was amended prior to passage to require willful participation as a prerequisite to liability. I would conclude a brief paragraph (a sentence or two) with your statement that "the comment, in context, sheds no light whatever on the meaning of § 10(b)".

The remainder of note 20, in its present form, considers arguments advanced by industry representatives in hearings before the Committees. Rather than identify specific arguments, I would say merely that the Commission also seeks support for its position by relying on arguments made by industry representatives at the legislative hearings. A second sentence should be added consolidating the last two sentences presently in the note, namely, to the effect that testimony



during the course of Committee hearings, particularly by opponents to the legislation, is entitled to relatively little weight even when specifically relevant. (Citing your three cases). In this general connection, you might see if there is anything helpful in Schwegmann Bros. v. Calvert Corp., 341 U.S. 384, at 395.

L.F.P., Jr.



MEMORANDUM

TO: Mr. Greg Palm  
FROM: Lewis F. Powell, Jr.

DATE: February 19, 1976

No. 74-1042 Ernst & Ernst

I return herewith the latest draft, reflecting some editing and the addition of a number of riders. Also, I deliver a couple of memos on specific points.

Between the two of us, a draft has gone through so much piecemeal editing that it is difficult to judge whether it is in satisfactory form. Indeed, if we had not been short of secretarial help, I would have had the entire draft and notes recopied before undertaking my review. I had considerable trouble tying the footnotes to the text and even keeping the pages straight. In terms of substance, I continue to have some difficulty with the extent to which we rely on the language of 10(b) and the transition from Part II to Part III. I think the language of 10(b) comes very close to being so clear and unambiguous, in light of other provisions of the Acts, as to require no consideration of legislative history. I prefer, nevertheless, to leave Part III in our opinion, but I do not wish to imply - in our transition to Part III a any lack of confidence in Part II as actually controlling.

Thank you for your note 29 with respect to "policy considerations". I may try to revise and condense this, or I may abandon the idea entirely.



As to procedure from now on, I suggest the following:

1. Review my editing and changes, and discuss with me any questions of substance or major language changes that you think appropriate.

2. I do not think the draft is in satisfactory form to give to the printer. Therefore, I suggest that you give the notes to Gail and the text to Sally, each to copy such pages as may be necessary to give the printer something that is clean and clear enough to minimize printing time and error. I doubt that any printer could figure out where to go from the present state of things.

3. Except as to points that you specifically bring to my attention, I will not again review the draft until it is in printed form as a Chambers Draft. I believe the best way to progress this opinion is to get it in print. Then you, your editor (Carl, I believe) and I can go to work on it with the view to making it as coherently and carefully written as possible.

4. I intended saying above that, in reviewing this again, I hope you will omit or condense any footnote that does not contribute something necessary or worthwhile to the opinion. Some of the notes seem to me to be quite marginally relevant.

5. As you may know, each of us is called on now at Friday Conferences to state the status of circulated opinions. I certainly want to circulate Ernst & Ernst prior to the



Court Conference on Friday, March 5. This means that I will have to have a Chambers printed draft no later than the weekend of March 28-29.

L.F.P., Jr.



MEMORANDUM

TO: Greg Palm  
FROM: Lewis F. Powell, Jr.

DATE: February 19, 1976

No. 74-1042 Ernst & Ernst

I am not content with Part III, at least on the basis of my understanding of the situation.

The petitioner for certiorari did not present § 17(a) as an issue, and no cross petition presented it. As I dictate this, I have had no opportunity to review the bill of complaint. My recollection, however, is that it is predicated solely on 10(b) and 10b-5.

My recollection is that, at the oral argument, Mr. King spoke of amending the complaint to aver a cause of action under 17(a). (It is possible that my recollection - which is not sharp - is related to a proposed amendment for some other purpose).

This litigation has been going on for many years. If there is any way to avoid it, I do not wish to saddle the lower federal courts with another year or two of pointless litigation. I think there is no merit whatever to the 17(a), but persistent plaintiffs may find it profitable nevertheless to continue the litigation.



If indeed the complaint does not allege such a cause of action, and in the absence of any effort prior to this Court to amend the complaint, I would dispose of this issue simply and briefly in a footnote to the effect that respondents belatedly, after the petition for certiorari had been filed and granted attempted to raise an issue not specified in their complaint. Accordingly, the issue is not before us. I would simply reverse the case and if they want to initiate a new proceedings let them go to it below but without any assist from us.

L.F.P., Jr.



We might add something along the following lines at an appropriate place in the opinion. It should come up near the beginning or at the end.

We took this case to resolve the long-standing conflict as to the standard of liability under § 10(b). As we find its language and history dispositive of the issue, there is no occasion to consider whether policy considerations - that may have influenced the lawmakers - are relevant to the ascertainment of congressional intent. We do note that the standard of liability urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the two Acts. Last Term, in Blue Chip Stamps, 421 U.S. at 747-748, the Court pertinently observed:

(here copy the quote from Blue Chip that Greg has in his first draft of this note)

This case, on its facts, may illustrate an extreme example of the reach of the standard urged by respondents. They



sought to impose substantial personal liability for damages for alleged negligent conduct upon which respondents conceded that they did not rely. Acceptance of their view would indeed extend the "hazards" of rendering expert advice under the Acts to new frontiers, raising serious policy questions not yet addressed by Congress.



Supreme Court of the United States  
Washington, D. C. 20543



CHAMBERS OF  
JUSTICE POTTER STEWART

March 10, 1976

No. 74-1042 - Ernst & Ernst

Dear Lewis,

I am glad to join your opinion  
for the Court in this case.

Sincerely yours,

P.S.  
/

Mr. Justice Powell

Copies to the Conference



Supreme Court of the United States  
Washington, D. C. 20543

CHAMBERS OF  
JUSTICE WILLIAM H. REHNQUIST



March 11, 1976

Re: No. 74-1042 - Ernst & Ernst v. Hochfelder

Dear Lewis:

Please join me.

Sincerely,

A handwritten signature, likely "WHR", is written below the word "Sincerely,".

Mr. Justice Powell

Copies to the Conference



Supreme Court of the United States  
Washington, D. C. 20543

CHAMBERS OF  
JUSTICE BYRON R. WHITE

March 15, 1976

Re: No. 74-1042 - Ernst & Ernst v. Hochfelder

Dear Lewis:

Please join me in your very good opinion  
in this case.

Sincerely,

*Byron*

Mr. Justice Powell

Copies to Conference



Supreme Court of the United States  
Washington, D. C. 20543

CHAMBERS OF  
JUSTICE WM. J. BRENNAN, JR.

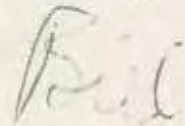
March 25, 1976

RE: No. 74-1042 Ernst & Ernst v. Hochfelder, et al.

Dear Harry:

Please join me in your dissenting opinion in the  
above.

Sincerely,



Mr. Justice Blackmun

cc: The Conference



Supreme Court of the United States  
Washington, D. C. 20543

CHAMBERS OF  
THE CHIEF JUSTICE

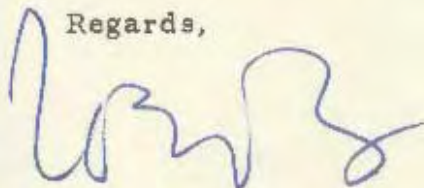
March 26, 1976

Re: 74-1042 - Ernst & Ernst v. Hochfelder

Dear Lewis:

Please join me in your circulation of March 11.

Regards,



Mr. Justice Powell

Copies to the Conference



Respondents in this case were customers of a small brokerage firm/largely owned by its president, Leston B. Nay. Respondents were induced by Nay to invest in a fraudulent securities scheme. The firm went bankrupt and Nay committed suicide.

Petitioners in this case, Ernst & Ernst, had audited the firm's books for many years. They did not discover the fraud because Nay was careful to maintain no records, ~~of it~~. His technique included a rule/that he alone was authorized to open all mail addressed to his attention.

After the bankruptcy, respondents sued the accounting firm/alleging that it was negligent in failing to have discovered Nay's rule/with respect to opening mail. The theory was/that if discovered, that rule should have aroused the suspicion of the auditing firm/and ~~that~~ upon investigation, the fraud would have been revealed.

The<sup>14</sup> suit was brought under § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. The Court of Appeals for the Seventh Circuit, reversing the District Court, held that respondents had stated a valid cause of action for damages, even though only negligence had been alleged. *There was no allegation of fraud or wilful misconduct by E & E.*

*Sec. 10(b) speaks*



Section 10(b) speaks of manipulative/and deceptive devices/or contrivances. These words reflect a congressional intention to proscribe a type of conduct quite different from negligence. Indeed, the language Congress chose in other sections of the Securities Acts, ~~clearly~~ <sup>that are</sup> directed to negligent conduct, stands in sharp contrast to the language of § 10(b).

The legislative history of the 1934 Act, as well as the overall pattern of express civil liabilities created by the Acts, also supports the view that § 10(b) is not directed at merely negligent conduct.

There was no allegation in this case of intentional or willful conduct designed to deceive or defraud investors.

For reasons more fully set forth in the opinion for the Court, we ~~think~~ <sup>conclude that</sup> the Court of Appeals erred in reading a negligence standard into § 10(b) and Rule 10b-5. Accordingly, we reverse its judgment.

\* \* \* \*

Mr. Justice Blackmun has filed a dissenting opinion in which Mr. Justice Brennan joins. Mr. Justice Stevens took no part in the consideration or decision of the case.



April 6, 1976

Cases Held for No. 74-1042 ERNST & ERNST v. HOCHFELDER

MEMORANDUM TO THE CONFERENCE:

There are three cases being held for ERNST & ERNST, two of which are related and will be discussed together:

No. 74-1366, Schaefer v. First National Bank of Lincolnwood, and No. 74-1407 Rodman & Renshaw v. Schaefer.

The petitions in these cases arise from a complex stock fraud. A number of persons, including an employee of the petitioner brokerage firm in No. 74-1407 [hereinafter Rodman & Renshaw] conspired to drive up the price of the stock of a certain corporation in order to facilitate a merger. Petitioners in No. 74-1366 [hereinafter Schaefer] were purchasers of the shares during the period in which their market price was artificially inflated. They brought this civil action under § 1 of the Sherman Act and various sections of the Securities Act of 1933 and the Securities Exchange Act of 1934.

CA 7 held that Schaefer had a cause of action under § 10(b) and Rule 10b-5 despite the express remedy for price manipulation in § 9 of the 1934 Act and that the applicable state statute of limitations for civil actions under § 10(b) was equitably tolled because Rodman & Renshaw had facilitated the fraud of their employee through negligence. The court further held that Schaefer's Sherman Act claim was incompatible with the damage remedies under the Securities Acts.



Rodman & Renshaw assert that an implied cause of action under § 10(b) and Rule 10b-5 should not be permitted where the facts alleged constitute a legitimate claim under § 9(a)(2) of the 1934 Act since this will permit plaintiffs to circumvent the statute of limitations provided under § 9(e). They also challenge the equitable toll of the statute of limitations, and contend that if there is a § 10(b) claim, § 9(e), rather than state law, provides the relevant period of limitations.

The question whether an implied cause of action is appropriate under § 10(b) for stock price manipulation in view of the express cause of action under § 9(a)(2), is certainly not frivolous. The procedural restrictions provided by § 9(e) would indeed be circumvented by permitting actions under § 10(b). Section 9(a)(2) covers manipulative conduct on national securities exchanges for the "purpose of inducing the purchase or sale of such security by others." The applicability of § 10(b) is not limited to national exchanges and it contains no special notice requirement other than general scienter. Thus, this is a case in which the implied cause of action under § 10(b) would totally nullify the restrictions on the express action under § 9(a)(2). Compare Ernst & Ernst, slip op. 22-24 & n. 31 with SEC v. National Securities, Inc., 393 U.S. 453, 468 (1969).

Rodman & Renshaw cite no cases in direct conflict with CA 7's holding. Moreover, the attractiveness of this case as a vehicle for resolving this issue is diminished by the fact that this is an appeal from pre-trial motions for summary judgment and the district court expressly noted that there was a disputed issue of fact whether the § 9(e) statute of limitations had in fact run in this case. Depending upon how the "purpose" clause of § 9(a)(2) is construed, the action here thus might be sustainable under that section.

The basis for CA 7's resolution of the tolling issue is not entirely clear. In reaching its conclusion



the court relied principally on its decision in Ernst & Ernst which held that negligent facilitation of fraud may justify tolling. But it also noted that in the original complaint Schaefer had alleged direct participation by Rodman & Renshaw in the fraud. The issue whether the statute of limitations under § 9 should be applied in § 10(b) actions apparently was not raised below. Rodman & Renshaw do not raise the issue of the appropriateness of premising a § 10(b) action on allegations of negligent facilitation of fraud. In any event, this case would not necessarily be controlled by Ernst & Ernst, as the perpetrator of the fraud here was a Rodman & Renshaw employee.

Ernst & Ernst has no direct bearing on the appropriate resolution of the issues raised in the Rodman & Renshaw petition, none of which in my view merit review at this time. Accordingly, I will vote to deny the petition in No. 74-1407.

\* \* \* \*

As to the implied repeal of the Sherman Act as urged by Schaefer, CA 7's holding that the existence of the damage remedies under the Securities Acts rendered "superfluous" private remedies under the antitrust laws is questionable. As the Solicitor General points out in his amicus brief, however, the circumstances of this case are rather unique. Neither Schaefer nor the S.G. is aware of any prior cases in which manipulations of securities, as distinguished from commodities, have been challenged as violative of both the antitrust and securities laws. I agree with the S.G. that the case does not merit review by this Court and, accordingly, will vote to deny the petition in No. 74-1366.



No. 75-1065 John Nuveen & Co., Inc. v. Sanders

This case concerns the application of § 10(b) and Rule 10b-5 to dealers in commercial paper. CA 7 held that commercial paper with a maturity of 90 days constituted "securities" within the meaning of the Securities Exchange Act of 1934, despite the definition of "security" in § 3(a)(10) of that Act which expressly states that the term "shall not include . . . any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months . . . ." The court further held that the petitioner, a dealer in commercial paper, was liable for civil damages under § 10(b) and Rule 10b-5 to purchasers of such paper for failure to make an adequate investigation of the financial strength of the issuer corporation. Although CA 7 purported not to rely on a "mere negligence" standard, it is evident from the opinion that petitioner was held liable without any proof of "scienter", as that term is used in Ernst & Ernst. Petitioner's liability was premised on the fact that it had failed to make a "reasonable investigation" of the issuer, CA 7 noting that petitioner had "acted in the mistaken, but honest belief that financial statements prepared by certified public accountants correctly represented the condition of the issuer . . . ." Pet. App. 1.

Petitioner challenges each of these holdings. Although the issue of the scope of the term "security" under the 1934 Act is important, in view of the liability standard under § 10(b) and Rule 10b-5 adopted by CA 7, I will vote to grant, vacate, and remand in light of Ernst & Ernst.

L.F.P., Jr.

LFP/gg







D

PETITION FOR REHEARING

May 15, 1976 Conference  
List 3, Sheet 3

No. 74-1042

ERNST & ERNST

v.

HOCHFELDER

1. Resps seek rehearing in this case decided on Mar. 30, 1976, on the "sole issue" that this Court was wrong in stating that resps had only proceeded on a theory of negligence. Thus, resps contend, summary judgment was inappropriate. Resps contend that negligence was not mentioned in the complaint. The only mention of negligence was in answer to an interrogatory in which they said they were not charging petr with intentional fraud but with inexcusable negligence. Resps then

Deny  
Greg



contend that this case charges petr with deliberate failure to perform a duty. This, resps contend, is fraud, not negligence.

2. Resps appear to be trying to say that the answer to the interrogatory should be ignored. However, the Court noted it in footnote 5 and Part III. The dissent in Ernst & Ernst does not discuss this issue.

Kovacic

5/4/76

DK



Greg - Note my relatively  
minor editing. I think  
the opinion is now in fine  
shape & quite unanswerable. But no doubt  
thoughtful editing by your fellow critics  
CHAMBERS DRAFT will improve the  
draft.

File  
L.F.P

2/25  
SUPREME COURT OF THE UNITED STATES

No. 74-1042

Ernst & Ernst, Petitioner,  
v.  
Olga Hochfelder et al. } On Writ of Certiorari to the  
United States Court of Ap-  
peals for the Seventh Cir-  
cuit.

[March —, 1976]

MR. JUSTICE POWELL delivered the opinion of the  
Court.

The issue in this case is whether an action for civil  
damages may lie under § 10 (b) of the Securities Ex-  
change Act of 1934 (the 1934 Act), 48 Stat. 891, 15  
U. S. C. § 78j (b), and Securities and Exchange Com-  
mission Rule 10b-5, 17 CFR § 240.10b-5, in the absence  
of an intent to deceive, manipulate, or defraud on the  
part of the defendant.

I

Petitioner, Ernst & Ernst, is an accounting firm. From  
1946 through 1967 it was retained by First Securities  
Company of Chicago (First Securities), a small broker-  
age firm and member of the Midwest Stock Exchange  
and the National Association of Securities Dealers, to  
perform periodic audits of the firm's books and records.  
In connection with these audits Ernst & Ernst prepared  
for filing with the Securities and Exchange Commission  
(the Commission) the annual report for First Securities,  
as required by § 17 (a) of the 1934 Act, 15 U. S. C. § 788  
(a).<sup>2</sup> It also prepared for First Securities responses

<sup>2</sup> Section 17 (a) requires that securities brokers or dealers  
"make . . . and preserve . . . such accounts . . . books, and other

Unless this  
process results  
in changes  
of substance  
or major  
language  
changes, we  
can go to  
a 1<sup>st</sup> Draft.

The cite  
checking of  
this opinion  
will require  
the infinite  
care and  
patience  
which is  
characteristic  
of your work.

L.F.P

(Greg - Keep this copy ~~for~~ for my future  
Sally reference)



to the financial questionnaires of the Midwest Stock Exchange.

Respondents were customers of First Securities who invested in a fraudulent securities scheme perpetrated by Leston B. Nay, president of the firm and owner of 92% of its stock. Nay induced the respondents to invest funds in "escrow" accounts that he represented would yield a high rate of return. Respondents did so from 1942 through 1966, with the majority of the transactions occurring in the 1950's. ~~The escrow fund~~ transactions were not in the customary form of dealings between First Securities and its customers. Typically, the respondents sold legitimate securities through First Securities to obtain funds to invest in ~~the~~ escrow accounts. They then drew their personal checks payable to Nay or the bank for his account. No such ~~escrow~~ accounts were reflected on the books and records of First Securities, and none was shown on its periodic accounting to respondents. Nor were they included in First Securities' filings with the Commission or the Exchange. In fact, there were no escrow accounts as Nay converted re-

These

what they  
believed  
were

records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." During the period relevant here, Commission Rule 17a-5, 17 CFR § 240.17a-5, required that the reports of financial condition include a certificate stating "clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." See SEC Release No. 3338 (Nov. 28, 1948), X-17A-5 (h). The rule required Ernst & Ernst to state in its certificate, *inter alia*, "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances" and provided that nothing should "be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit for the purpose of expressing the opinions" required by the rule.



spondents' funds to his own use immediately upon receipt.

5 This fraud came to light in 1968 when Nay committed suicide, leaving a note describing First Securities as bankrupt and the escrow investments as "spurious." Respondents subsequently filed this action<sup>2</sup> for damages against Ernst & Ernst<sup>3</sup> in the United States District Court for the Northern District of Illinois under § 10 (b) of the 1934 Act. The complaint charged that Nay's escrow scheme violated § 10 (b) and Rule 10b-5 of the Commission,<sup>4</sup> and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct a proper audit of First Securities. As revealed through discovery, respondent's cause of action rested on a theory of negligent misfeasance. The premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm

<sup>2</sup> Two separate, but substantially identical, complaints initially were filed by different groups of respondents. Subsequently the respondents jointly filed a First Amended Complaint. The two cases were treated by the District Court as if they were consolidated and were consolidated formally on appeal.

<sup>3</sup> The first count of the complaint was directed against the Midwest Stock Exchange, charging that through its act and omissions it had aided and abetted Nay's fraud. Summary judgment in favor of the Exchange was affirmed on appeal, *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d 364 (CA7), cert. denied, 419 U. S. 875 (1974).

<sup>4</sup> Immediately after Nay's suicide the Commission commenced receivership proceedings ~~as to~~ First Securities. In those proceedings all of the respondents except two asserted claims based on the fraudulent escrow accounts. These claims ultimately were ~~upheld~~ in *SEC v. First Securities Co.*, 463 F. 2d 981, 986 (CA7 1972), cert. denied, 409 U. S. 880 (1973), where the court held that Nay's conduct violated § 10 (b) and Rule 10b-5, and that First Securities was liable for Nay's fraud as an aider and abettor. The question of Ernst & Ernst's liability was not considered in that case.

against

allowed



said to prevent an effective audit. The practice principally relied on was Nay's rule that only he could open mail addressed to him at First Securities or addressed to First Securities to his attention, even if it arrived in his absence. Respondents contended that if Ernst & Ernst had conducted a proper audit, it would have discovered this "mail rule." The existence of the rule then would have been disclosed in reports to the Midwest Stock Exchange and to the Commission, and this would have led to an investigation of Nay that would have revealed the fraudulent scheme. Respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.<sup>8</sup>

After extensive discovery the District Court granted Ernst & Ernst's motion for summary judgment and dismissed the action. The court rejected Ernst & Ernst's contention that a cause of action for aiding and abetting a securities fraud could not be maintained under § 10 (b) or Rule 10b-5 merely on allegations of negligence. It concluded, however, that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards.<sup>9</sup>

---

<sup>8</sup> In their response to interrogatories in the District Court respondents conceded that "[w]e do not accuse Ernst & Ernst of deliberate, intentional fraud," merely with "inexcusable negligence." App. 81.

<sup>9</sup> The District Court also held that respondents' action was barred by the doctrine of equitable estoppel and the applicable state statute of limitations of three years. See n. 27, *infra*. As customers of First Securities some of the respondents were sent confirmation forms as required under § 17 (a) and Rule 17a-5 requesting that they verify the accuracy of the statements and notify Ernst & Ernst as to any exceptions. Although the confirmation forms contained no reference to the escrow accounts, Ernst & Ernst were not notified of this fact. The last audit of First Securities by Ernst & Ernst



The Court of Appeals for the Seventh Circuit reversed and remanded. 503 F. 2d 1110 (1974). That court held that one who breaches a duty of inquiry and disclosure owed another can be liable in damages for aiding and abetting a third party's violation of Rule 10-b upon demonstrating that but for the breach the fraud would have been discovered or prevented. *Id.*, at 1104.<sup>7</sup> The court reasoned that Ernst & Ernst had a common-law and statutory duty of inquiry as to the adequacy of First Securities' internal control system because it had contracted to audit First Securities and to prepare for filing with the Commission the annual report of its financial

was completed in December 1967 and the first complaint in this action was not filed until February 1971.

<sup>7</sup> In support of this holding, the Court of Appeals cited its decision in *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d 364 (CA7 1974), where it stated that a claim for aiding and abetting a securities fraud solely by inaction could be maintained under Rule 10b-5. In such case the plaintiff must show "that the party charged with aiding and abetting had knowledge of or, but for the breach of a duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." *Id.*, at 374. The court explained in this case that these "elements constitute a flexible standard of liability which should be amplified according to the peculiarities of each case." 503 F. 2d, at 1104. In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10 (b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule, nor the elements necessary to establish such a cause of action. See, e. g., *Brennan v. Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (ND Ind. 1966), 286 F. Supp. 702 (ND Ind. 1968), *aff'd*, 417 F. 2d 147 (CA7 1969), *cert. denied*, 397 U. S. 989 (1970) (defendant held liable for giving active and knowing assistance to a third party engaged in violations of the securities laws). See generally Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597, 620-645 (1972).

greg - This  
is an awkward  
sentence. I  
doubt that the  
sentence adds  
anything. I'm  
inclined to  
leave it out  
~~as an~~  
redundant.



condition required under § 17 of the 1934 Act and Rule 17a-5, 17 CFR § 240. 17a-5.<sup>8</sup> The Court further reasoned that respondents were beneficiaries of the statutory duty to inquire,<sup>9</sup> and the related duty to disclose any material irregularities that were discovered. *Id.*, at 1105-1111. The court concluded that there were genuine issues of fact as to whether Ernst & Ernst's failure to discover and comment upon Nay's mail rule<sup>10</sup> constituted a breach of its duties of inquiry and disclosure, *id.*, at 1111, and whether inquiry and disclosure

<sup>8</sup> See n. 1, *supra*.

<sup>9</sup> The court concluded that the duty of inquiry imposed on Ernst & Ernst under § 17 (a) was "grounded on a concern for the protection of investors such as [respondents]," without reaching the question whether the statute imposed a "direct duty" to the respondents. 503 F. 2d, at 1105. The court recognized that Ernst & Ernst owed no common-law duty of inquiry to respondents arising from its contract with First Securities since Ernst & Ernst did not specifically foresee that respondents limited class might suffer from a negligent audit, compare *Glanzer v. Shepard*, 233 N. Y. 236, 135 N. E. 275 (1922), with *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931), see, e. g., *R. I. Hospital Trust Nat'l Bank v. Swartz*, 455 F. 2d 847, 851 (CA4 1972). Indeed, respondents conceded that they did not rely on the financial statements and reports prepared by Ernst & Ernst or on its certificate of opinion. 503 F. 2d, at 1107.

<sup>10</sup> In their briefs respondents allude to several other alleged failings by Ernst & Ernst in its audit of First Securities, principally its failure to inquire into the collectibility of certain loans by First Securities to Nay and its failure to follow up on a 1965 memorandum that characterized First Securities' overall system of internal control as weak because of the centralization of functions in the cashier. The Court of Appeals mentioned none of these alleged deficiencies in its opinion in this case, although it did discuss some of them in its opinion in *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d, at 370-371, holding that they were insufficient to put the Exchange on notice that further inquiry into First Securities' financial affairs was required.



would have led to the discovery or prevention of Nay's fraud. *Id.*, at 1115.<sup>11</sup>

We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10 (b) and Rule 10b-5 in the absence of any allegation of scienter—an intent to deceive, manipulate, or defraud.<sup>12</sup> 421 U. S. 909 (1975). We conclude that it will not and therefore we reverse.<sup>13</sup>

<sup>11</sup> The Court of Appeals also reversed the District Court's holding with respect to Ernst & Ernst's equitable estoppel and statute of limitations defenses. See n. 6, *supra*. In view of our disposition of the case we need not address the issues raised by these defenses.

<sup>12</sup> Although the verbal formulations of the standard to be applied have varied, several courts of appeals in substance have held that negligence alone is sufficient for civil liability under § 10 (b) and Rule 10b-5. See, e. g., *White v. Abrams*, 495 F. 2d 724 (CA9 1974) (flexible duty standard); *Myzel v. Fields*, 386 F. 2d 718, 735 (CA8 1967), cert. denied, 390 U. S. 951 (1968) (negligent misfeasance sufficient for liability); *Kohler v. Kohler Co.*, 319 F. 2d 634 (CA7 1963) (knowledge not required). Other courts of appeals have held that some type of "scienter"—i. e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud—is necessary in such an action. See, e. g., *Clegg v. Conk*, 507 F. 2d 1351, 1361-1362 (CA10 1974), cert. denied, 422 U. S. 1007 (1975) (something more than ordinary negligence); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1306 (CA2 1973) ("willful or reckless disregard" of the truth). But few of the decisions announcing that some form of negligence suffices for civil liability under § 10 (b) and Rule 10b-5 have involved only negligent conduct. *Smallwood v. Pearl Brewing Co.*, 489 F. 2d 579, 606 (CA5 1974), cert. denied, 419 U. S. 879 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 286 (CA3 1972) (Adams, J., concurring); *Bucklo*, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 568-570 (1972).

In this opinion the term "scienter" refers to a mental state embracing an intent to deceive, manipulate, or defraud. In certain areas of the law reckless disregard of the truth is considered equivalent to knowledge for purposes of imposing liability for some act. We need not here address the question whether, in some circum-

[Footnote 13 is on p. 8]



## II

Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929. The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended 15 U. S. C. § 77a et seq., was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H. R. Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges. See S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934). Although the Acts contain numerous carefully drawn express civil remedies and criminal penalties, Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the 1934 Act Congress created the Commission, providing it

stances, reckless behavior is sufficient for civil liability under § 10 (b) and Rule 10b-5.

<sup>10</sup> Respondents contend that Ernst & Ernst owed them a direct duty under § 17 (a) and Rule 17a-5 of the 1934 Act to conduct a proper audit of First Securities and that they may premise a private cause of action against Ernst & Ernst for violation of that duty. Respondents' original cause of action, however, was premised solely on alleged aiding and abetting violation of § 10 (b) and Rule 10b-5. During the lengthy history of this litigation they ~~apparently made no motion to amend their original complaint to include a damage action under § 17 (a) and Rule 17a-5.~~ We do not think that respondents should be permitted to raise this new cause of action for the first time in this Court.

We therefore do not consider that a claim of liability under § 17(a) is properly before us even if respondents could assert such a claim independently of § 10(b).

Greg - Are any cases cited supporting an independent cause of action under 17(a)?

now further

have not

over a cause of ~~action~~



with an arsenal of flexible enforcement powers. See, e. g., 1933 Act §§ 8, 19, 20, 48 Stat. 79, 85, 86, as amended, 15 U. S. C. §§ 77h, 77s, 77t; 1934 Act §§ 9, 19, 21, 48 Stat. 889, 898, 899, as amended, 15 U. S. C. §§ 78i, 78s, 78u.

Section 10 of the 1934 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." 15 U. S. C. § 78j. In 1942, acting pursuant to the power conferred by § 10 (b), the Commission promulgated Rule 10b-5, which provides:

"Employment of manipulative and deceptive devices

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,  
"(1) to employ any device, scheme, or artifice to defraud,

"(2) 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

"(3) 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."

Although § 10 (b) does not by its terms create an express civil remedy for its violation, and there is no



indication that Congress,<sup>14</sup> or the Commission when adopting Rule 10b-5,<sup>15</sup> contemplated such a remedy, the existence of a private cause of action for violations of the Rule is now well established. *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U. S. 128, 150-154 (1972); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U. S. 6, 13 n. 9 (1971). During the 30-year period since a private cause of action was first implied under § 10 (b) and Rule 10b-5,<sup>16</sup> a substantial body of case law and commentary has developed as to its elements. Courts and commentators long have differed as to whether scienter is a necessary element of such a cause of action, or whether negligent conduct alone is sufficient.<sup>17</sup> In addressing this question, we turn first to the language of § 10 (b), for the "starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps*, *supra*, at 756 (Powell, J., concurring). *E. g.*, *FTC v. Bunte Brothers*, 312 U. S. 349, 350 (1941).

<sup>14</sup> See, e. g., S. Rep. No. 792, 73d Cong., 2d Sess., pp. 5-6 (1934); Note, Implied Liability Under the Securities Exchange Act, 61 Harv. L. Rev. 859, 861 (1948).

<sup>15</sup> See, e. g., *Birnbaum v. Newport Steel Corp.*, 193 F. 2d 461, 463 (CA2), cert. denied, 343 U. S. 956 (1952); 3 Loss, Securities Regulation 1469 n. 87 (2d ed. 1961).

<sup>16</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (1946).

<sup>17</sup> See cases cited in n. 12, *supra*. Compare, e. g., Comment, Scienter and Rule 10b-5, 69 Col. L. Rev. 1057, 1080-1081 (1969); Note, Negligent Misrepresentations under Rule 10b-5, 32 Chi. L. Rev. 824, 835-836 (1965); Note, 82 Harv. L. Rev. 938, 947 (1969); Note, Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L. J. 658, 682-689 (1965), with, e. g., 3 Loss, *supra*, at 1766; 6 *id.*, at 3883-3885 (Supp. 1969).

*Ernst & Ernst v. Hochfelder*  
 Judge  
 as credit  
 but concerning him  
 concerning op.  
 in this case



## A

Section 10 (b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10 (b) was intended to proscribe knowing or intentional conduct. See *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 868 (CA2 1968) (Friendly, J., concurring), cert. denied *sub nom. Kline v. SEC*, 394 U. S. 976 (1969); Loss, Summary Remarks, 30 Bus. Lawyer 163, 165 (1975). See also *Kohn v. American Metal Climax*, 458 F. 2d 255, 280 (CA3 1972) (Adams, J., concurring).

In its *amicus curiae* brief, however, the Commission contends that nothing in the language "any manipulative device or contrivance" limits its operation to knowing and intentional practices.<sup>12</sup> In support of its view, the Commission cites the overall congressional purpose

<sup>12</sup> The Commission, however, would not permit recovery upon proof of negligence in all cases. In light of the limitations that Congress has placed on the express civil remedies in the 1933 and 1934 Acts, see pp. ———, *infra*, the Commission would limit the circumstances in which civil liability could be imposed for negligent violation of Rule 10b-5 to situations in which (i) "the defendant knew or reasonably could foresee that the plaintiff would rely on his conduct, (ii) the plaintiff did in fact so rely, and (iii) the amount of the plaintiff's damages caused by the defendant's conduct was definite and ascertainable." Brief of *Amicus Curiae* 23-33. The Commission concludes that the present record does not establish these conditions for civil liability since respondents in fact did not rely on Ernst & Ernst's audits, the financial statements of First Securities could not have been reasonably foreseen as likely to induce respondents to invest in the escrow accounts, and the amount of respondents' damages was unascertainable. *Id.*, 33-36. Respondents accept the Commission's analysis of the operative language of the statute and Rule, but reject these additional requirements for recovery for negligent violations.



in the 1933 and 1934 Acts to protect investors against false and deceptive practices that may injure them. *Affiliated Ute Citizens v. United States*, 406 U. S., at 151; *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U. S., at 11-12; *J. I. Case Co. v. Borak*, 377 U. S. 426, 433 (1971); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1963). The Commission then reasons that since the "effect" upon investors of given conduct is the same whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission is unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning. See, e. g., *Addision v. Holly Hill Co.*, 32 U. S. 607, 617-618 (1944).<sup>20</sup> The Commission's argument simply ignores the use of the words "device" or "contrivance," terms that make unmistakable a congressional intent to proscribe a type of con-

<sup>20</sup> "We should of course be faithful to the meaning of a statute. But after all Congress expresses its meaning by words. If legislative policy is couched in vague language, easily susceptible of one meaning as well as another in the common speech of men, we should not stifle a policy by a . . . grudging process of construction. To let words draw on some purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another . . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him." 322 U. S., at 617-618. See Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Col. L. Rev. 527, 536-537 (1947).

2- The  
 already  
 refers to  
 the "Commission"  
 we find

duct quite different from negligence.<sup>20</sup> Few concepts in the law are more familiar than that of negligence. One must assume that if Congress had intended to extend the reach of § 10 (b) to embrace negligent conduct it would have said so in conventional, commonly accepted terms.

In addition to relying upon the Commission's argument with respect to the operative language of the statute, respondents contend that since we are dealing with "remedial legislation," *Tcherepnin v. Knight*, 389 U. S. 332, 336 (1967), it must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens v. United States*, 406 U. S., at 151. This argument assumes that "remedial purposes" of the Act embrace as a minimum a negligence standard of liability. But in seeking to accomplish its broad remedial goals, Congress did not elect a single or uniform standard of civil liability even as to express civil remedies. In some circumstances and with respect to certain classes of defendants, Congress did create express liability predicated upon a failure to exercise reasonable care, e. g., 1933 Act § 11 (b) (liability of persons such as accountants or lawyers for misleading statements in portions of registrations statements for which they are responsible). In other situations good faith is an absolute defense, 1934 Act § 18, 15 U. S. C. § 78r

<sup>20</sup> Webster's Int'l Dictionary (2d ed. 1934) defines "device": "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice" and "contrivance" in pertinent part as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "To devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . . ." The Commission also ignores the use of the terms "[t]o use or employ," language that is supportive of the view that Congress did not intend § 10 (b) to embrace negligent conduct.



(misleading statements in any document filed pursuant to the Act), while in other circumstances Congress created express liability regardless of the defendant's fault, 1933 Act § 11 (issuer liability for misleading statements in the registration statement).

It is thus evident that Congress imposed express civil liability in the 1933 and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Act must therefore rest primarily on the language of that section. Where, as here, we deal with a judicially implied liability, the statutory language certainly is no less important. In view of the language of § 10 (b) which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its context, *United States v. Oregon*, 366 U. S. 643, 648 (1961); *Packard Motor Car Co. v. NLRB*, 330 U. S. 485, 492 (1947), further inquiry may be unnecessary. We turn now, nevertheless, to the legislative history of the 1934 Act to ascertain whether there is support for the meaning attributed to § 10 (b) by the Commission and respondents.

## B

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, that history supports our conclusion that § 10 (b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.

The original version of what would develop into the 1934 Act was contained in identical bills introduced by Senator Fletcher and Representative Rayburn. S. 2693, 73d Cong., 2d Sess. (1934). H. R. 7852, 73d Cong., 2d

✓  
we think  
the relevant  
portions of

Sess. (1934). Section 9 (c) of the bills, from which present § 10 (b) evolved, proscribed as unlawful the use of "any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors." The other subsections of proposed § 9 listed specific practices that Congress empowered the Commission to regulate through its rulemaking power. See §§ 9 (a) ("short sale"), (b) ("stop-loss order"). Soon after the hearings on the House bill were held, a substitute bill was introduced which abbreviated and modified § 9 (c)'s operative language to read "any manipulative device or contrivance." S. 3420, 73d Cong., 2d Sess., 9 (c) (1934); H. R. 7852, 73d Cong., 2d Sess., 9 (c) (1934). Still a third bill, retaining the Commission's power to regulate the specific practices enumerated in the prior bills, and omitting all reference to the Commission's authority to prescribe rules concerning manipulative or deceptive devices in general, was introduced and passed in the House. H. R. 9323, 73d Cong., 2d Sess. (1934). The final language of § 10 is a modified version of a Senate amendment to this last House bill. See H. R. Rep. No. 1838, 73d Cong., 2d Sess., 32-33 (1934).

Neither the intended scope of § 10 (b) nor the reasons for the changes in its operative language are explicitly revealed in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation. There is no indication, however, that § 10 (b) was intended to proscribe conduct not involving scienter. The Senate Report discusses generally the various abuses that precipitated the need for the legislation and the inadequacy of self-regulation by the stock exchanges.

The Report then analyzes the component provisions



of the statute, but does not pare § 10. The only specific reference to § 10 in this discussion is the following:

"In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10 and 16." S. Rep. 792, 73d Cong., 2d Sess., 6 (1934).

In the portion of the general analysis section of the Report entitled "Manipulative Practices," however, there is a discussion of specific practices that were considered so inimical to the public interest as to be expressly prohibited, such as "wash" sales and "matched" orders,<sup>21</sup> and of other practices such as stabilization of security prices and grants of options, that might in some cases serve legitimate purposes. These latter practices were left to regulation by the Commission. Significantly, we think, in discussing these practices, there was no indication that any type of criminal or civil liability was to attach in the absence of scienter. For example, in discussing the potential abuses resulting from the use of options, the Report indicated that self-regulation by a

<sup>21</sup> Wash sales are transactions involving no change in beneficial ownership. Matched orders are orders for the purchase/sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security. Section 9(a)(1) of the 1934 Act, 15 U. S. C. § 78(a)(1), proscribes wash sales and matched orders when effectuated "[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange or . . . the market for any such security." See *In re J. A. Latimer & Co.*, 38 S. E. C. 790 (1958); *In re Thornton & Co.*, 28 S. E. C. 208 (1948).

Greg - This sentence is not a self-evident "example" of absence of scienter. Either omit or clarify along lines indicated on next pg.

securities exchange had proved inadequate because members might employ nonmembers, not bound by its rules, to execute transactions. *Id.*, 9. In commenting on the express civil liabilities provided in the 1934 Act, the Report explains:

"... the bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in good faith." *Id.*, at 12-13 (emphasis supplied).

The Senate Report thus reveals a congressional intent to prevent "manipulative and deceptive practices... which fulfill no useful function" and to create a private action for damages stemming from "illicit practices," where the defendant has not acted in good faith. There is no indication that Congress intended anyone to be made an insurer against potentially misleading conduct or misstatement unless he acted otherwise than in good faith.

The extensive hearings that preceded passage of the 1934 Act similarly touched only briefly on § 10, and most of the discussion was devoted to the enumerated devices now proscribed in § 10 (a). The most relevant exposition of the provision that was to become § 10 (b) was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:

"Subsection (c) [§ 9 (c) of H. R. 7852—later § 10

*deliberately circumvent  
the rules of the exchange  
by employing non-members*

*this  
Report  
and the*

*grea -  
whose does  
term "illicit  
practices"  
come from?*



(b)] says, 'Thou shalt not devise any other cunning devices.' . . .

"Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."

Hearings on H. R. 7852 and R. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934). This brief explanation of § 10 (b) by the spokesman for its drafters is significant. The section was described rightly as a "catch-all" clause to enable the Commission "to deal with new manipulative [or cunning] devices." It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions. Use of the word "manipulative" is especially significant. It is virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.<sup>22</sup> Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing manipulative or cunning conduct to include negligence.<sup>23</sup>

<sup>22</sup> See Webster's Int'l Dictionary (2d ed. 1934): "manipulate": "... to manage or treat artfully or fraudulently; as to manipulate accounts . . . 4. *Exchanges*. To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig."

<sup>23</sup> In support of its position the Commission cites a statement by Corcoran in the Senate hearings that "in modern society there are many things you have to make crimes which are sheer matters of negligence" and "intent is not necessary for every crime." Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., 6509-6510 (1934). The comment, taken in context, sheds no light on the meaning of § 10 (b).

was  
Corcoran  
"a" or "the  
spokesman?"

7

## C

The 1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities. See *Blue Chip Stamps*, *supra*, at 727-730. As the Court indicated in *SEC v. National Securities, Inc.*, 393 U. S. 453 (1969), "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen." Recognizing this, respondent and

The question had been raised whether criminal violations could arise under § 8 of S. 2693, 73d Cong., 2d Sess., which became § 9 of the 1934 Act, in the absence of specific intent to influence security prices for personal gain. Corcoran's remarks, however, were not addressed to the scope of § 8, but were general observations concerning activity society might proscribe under criminal law. Ferdinand Pecora, counsel to the committee, described the draft language as "[e]xcluding from its scope an act that is not done with any ulterior motives or purposes, as set forth in the act." *Id.*, 6510. Moreover, prior to the passage of the 1934 Act, § 8 was amended to require willful participation as a prerequisite to civil liability for violations. Compare § 9(c) of the 1934 Act with § 8 (c) of S. 2693.

The Commission further relies on objections to a draft version of § 10 (b)—§ 9 (c) of S. 2693 and H. R. 7852, see pp. ———, *supra*—raised by representatives of the securities industry in the House and Senate hearings. They warned that the language was so vague that the Commission might outlaw anything. *E. g.*, Hearings on Stock Exchange Practices, *supra*, at 6988; Hearings on H. R. 7852 and H. R. 8720, House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934), 258. Remarks of this kind made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill, are entitled to little weight. See, *e. g.*, *United States v. United Mine Workers*, 330 U. S. 258, 276-277 (1947); *United States v. Wrightwood Dairy Co.*, 315 U. S. 110, 125 (1942). This is especially so with regard to the statements of legislative opponents who "[i]n their zeal to defeat a bill . . . understandably tend to overstate its reach." *NLRB v. Fruit Packers*, 377 U. S. 58, 66 (1964). See *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U. S. 384, 394-395 (1951).



the Commission contrast § 10 (b) to other sections of the Acts to support their contention that civil liability may be imposed upon proof of negligent conduct. We think they misconceive the significance of the other provisions of the Act, in which we find evidence supportive of a requirement that an element of scienter be proved.

The Commission argues that Congress has been explicit in requiring willful conduct when that was the standard of fault intended, citing § 9 of the 1934 Act, 15 U. S. C. § 78, which generally proscribes manipulation of securities prices. Sections 9 (a)(1) and (2), for example, respectively prohibit manipulation of security prices "[f]or the purpose of creating a false or misleading appearance of actual trading in any security . . . or . . . with respect to the market for any such security," and "for the purpose of inducing the purchase or sale of such security by others." See also § 9 (a)(4). Section 9 (e) then imposes upon "[a]ny person who willfully participates in any act or transaction in violation of" other provisions of § 9 liability to anyone who purchased or sold a security at a price affected by the manipulative activities. From this the Commission concludes that since § 10 (b) is not by its terms explicitly restricted to willful, knowing, or purposeful conduct, it should not be construed in all cases to require more than negligent action or inaction as a precondition for civil liability.

The structure of the Acts does not support the Commission's argument. In each instance that Congress created express civil liability in both Acts it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake. See 1933 Act, §§ 11, 12, 15, 15 U. S. C. §§ 77k, 77l, 77o; 1934 Act §§ 9, 16, 18, 20, *id.*, §§ 78i, 78p, 78r, 78t. For example, § 11 of the 1933 Act unambiguously creates a private action for damages when a

*Greg - I have  
not attempted  
to verify this  
- as the  
Hunk your  
statement  
is accurate*

registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading. The issuer of the securities is held absolutely liable for any damages, within the limits specified by § 11 (e), resulting from such misstatement or omission. But experts such as accountants who have prepared portions of the registration statement are accorded a "due diligence" defense. In effect, this is a negligence standard. An expert may avoid civil liability with respect to the portions of the registration statement for which he is responsible by showing that "after reasonable investigation" he had "reasonable ground[s] to believe" that the statements for which he was responsible were true and there was no omission of a material fact.<sup>24</sup> § 11 (b)(3)(B)(i). See, e. g., *Escott v. Barchris Corp.*, 283 F. Supp. 643, 607-703 (SDNY 1968). The express recognition of a cause of action premised on negligent behavior in § 11 stands in sharp contrast to the language of § 10 (b), and significantly undercuts the Commission's argument.

Equally significant, while specifying negligence as a standard of fault in some circumstances under the 1933 Act, see §§ 11, 12 (2), 15, 15 U. S. C. §§ 77k, 77l, 77o,<sup>25</sup>

<sup>24</sup> Other individuals who sign the registration statement, directors of the issuer, and the underwriter of the securities similarly are accorded a complete defense against civil liability based on the exercise of reasonable investigation and a reasonable belief that the registration statement was not misleading. §§ 11 (b)(3)(A), (C), (D); (e). See, e. g., *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 575-583 (EDNY 1971) (underwriters, but not officer-directors, established their due diligence defense). See generally R. Jennings & H. Marsh, *Securities Regulation* 1018-1027 (3d ed. 1972), and sources cited therein; Folk, *Civil Liabilities under the Federal Securities Acts: The Barchris Case*, 55 Va. L. Rev. 199 (1969).

<sup>25</sup> Section 12 (2) creates potential civil liability for a seller of securities in favor of the purchaser for misleading statements or



Congress indicated no role for such a standard in the 1934 Act. Each of the express liability provisions of the 1934 Act, except those directed to specific classes of individuals such as directors, officers, or 10% beneficial holders of securities, see § 16 (b), 15 U. S. C. § 78p,<sup>20</sup> contains a state of mind requirement for civil liability requiring something more than negligence. Section 9 proscribes the manipulation of securities on national securities exchanges and creates potential civil liability for any person who "willfully participates" in such conduct. § 9 (e). Section 18 creates potential civil liability for misleading statements filed with the Commission, but provides the defendant with the defense that "he acted in good faith and had no knowledge that such statement was false or misleading." 15 U. S. C. § 78r. And § 20, 15 U. S. C. § 78t, which imposes liability upon "controlling persons" for violations of the Act by persons whom they control, exculpates a defendant who "acted in good faith and did not . . . induce the act . . . constituting the

---

omissions in connection with the transaction. The seller is exculpated if he proves that he did not know, or in the exercise of reasonable care, could not have known of the untruth or omission. Section 15 of the 1933 Act, as amended by § 208 of the 1934 Act, makes persons who "control" any person liable under § 11 or § 12 liable jointly and severally to the same extent as the controlled person, unless he "had no knowledge of or reasonable grounds to believe in the existence of facts by reasons of which the liability of the controlled person is alleged to exist." 15 U. S. C. § 77o. See Act of June 6, 1934, Pub. L. No. 291, c. 404, § 208, 48 Stat. 908.

<sup>20</sup> Section 16 (b) provides that a corporation may recapture for itself the profits realized on a purchase and sale, or sale and purchase, of its securities within six months by a director, officer, or beneficial owner of more than 10% of any class of the corporation's equity securities. See *Foremost-McKesson, Inc. v. Provident Securities Co.*, — U. S. — (1976); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U. S. 582 (1973); *Reliance Electric Co. v. Emerson Electric Co.*, 404 U. S. 418 (1972).

violation. . . ." In *Blue Chip Stamps, supra*, at 736, we noted the anomaly of imputing to Congress an intention "to expand . . . a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action" in the provisions of these Acts. The result urged here by respondents would be no less anomalous.

Finally, the express civil remedies in the 1933 Act allowing recovery for negligent conduct are subject to significant procedural restrictions not applicable under § 10 (b). Section 11 (e) of the 1933 Act, for example, authorizes the court to require a plaintiff bringing a suit under § 11, § 12 (2), or § 15 thereof to post a bond for costs, including attorneys' fees. Section 13 specifies a statute of limitations of one year from the violation, or three years from the offer or sale, applicable to actions brought under § 11, § 12 (2), or § 15. It also is significant that simultaneously with the adoption of the 1934 Act, Congress tightened the restrictions on § 11 and § 12 actions by amendment of the 1933 Act. Prior thereto, § 11 contained no provision for payment of costs. 48 Stat. 891. See Act of June 6, 1934, Pub. L. No. 291, c. 404, § 206 (e), 48 Stat. 907. The amendments also substantially shortened the statute of limitations provided by § 13 of the 1933 Act. Compare 1933 Act § 13, 48 Stat. 84, with 15 U. S. C. § 77m. See 1934 Act, § 207, 48 Stat. 908.<sup>27</sup> Absent substantial evidence in the legislative history to the contrary—and there is none—we are unwilling to assume that the judicially created private

<sup>27</sup> Since no statute of limitations is provided for civil actions under § 10 (b), as in other cases of judicially implied remedies, the law of limitations of the forum state is followed. See *Holmberg v. Armbrrecht*, 327 U. S. 392, 395 (1946), and cases cited therein. Although it is not always certain which state statute of limitations should be followed, such statutes of limitations usually are longer than the period provided under § 13. 3 Loss, *supra*, at 1773-1774.



damage remedy under § 10 (b) can be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Except for suits against issuers of securities, which are held absolutely liable for damages resulting from misleading registration statements, such an assumption would nullify the effectiveness of the carefully drawn restrictions on express private damages actions that Congress provided in the 1933 Act and the 1934 Amendments.<sup>28</sup> See, e. g., *Fischman v. Raytheon Manufacturing Co.*, 188 F. 2d 283 (CA2 1951); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 867-868 (Friendly, J., concurring); *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123, 124 (SD Pa. 1948); 3 Loss, *supra*, at 1787-1788; Jennings & Marsh, *Securities Regulation* (3d ed. 1972).

## D

We have addressed, to this point, primarily the language and history of § 10 (b). The Commission contends, however, that subsections (2) and (3) of Rule 10b-5 are cast in language which—if standing alone—could encompass both intentional and negligent behavior. These subsections respectively provide that it is unlawful “[t]o make any untrue statement of a material fact necessary in order to make the statements made in

<sup>28</sup> Congress regarded these restrictions on private damage actions as significant. In introducing Title II of the 1934 Act, Senator Fletcher indicated that the amendment to § 11 (e) of the 1933 Act, providing for potential payment of costs, including attorneys’ fees “is the most important [amendment] of all.” 78 Cong. Rec. 8660. One of its purposes was to deter actions brought solely for their potential settlement value. See *Blue Chip Stamps*, *supra*, at 740-741. This deterrent is lacking in the § 10 (b) context, in which a district court’s power to award attorneys’ fees is sharply circumscribed. See *Alaska Pipeline Service Co. v. Wilderness Society*, 421 U. S. 240 (1975) (“bad faith” requirement); *F. D. Rich Co. v. Industrial Lumber Co.*, 417 U. S. 116, 129 (1974).

light of the circumstances under which they were made, not misleading . . ." or "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . ." Viewed in isolation the language of subsection (2), and arguably that of subsection (3), could be read as proscribing any type of material misstatement or omission, or course of conduct, that has the effect of defrauding investors, whether negligently caused or otherwise.

We note first that such a reading cannot be harmonized with the administrative history of the Rule, a history making clear that when adopted the Commission intended it to apply only to activities that involved scienter.<sup>29</sup> More important, Rule 10b-5 was adopted

<sup>29</sup> Apparently the Rule was a hastily drafted response to a situation involving clear evidence of intentional misconduct. The Commission's Regional Administrator in Boston had reported to the Director of the Trading and Exchange Division that the president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at the resultant depressed prices, when in fact the business was doing exceptionally well. The Rule was drafted and approved on the day this report was received. See Conference on Codification of the Federal Securities Laws, 22 BUS. LAW. 793, 922 (1967) (remarks of Milton Freeman, one of Rule's co-drafters); *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S., at 767 (BLACKMUN, J., dissenting). Although adopted pursuant to § 10 (b), the language of the Rule appears to have been derived in significant part from § 17 of the 1933 Act, 15 U. S. C. § 78q, e. g., *ibid.*; *SEC v. Texas Gulf Sulfur Co.*, 401 F. 2d, at 867 (Friendly, J., concurring). There is no indication in the administrative history of the Rule that any of the subsections was intended to proscribe conduct not involving scienter. Indeed the Commission's Release issued contemporaneously with the Rule explained:

"The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers



pursuant to authority granted the Commission under § 10 (b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Dixon v. United States*, 381 U. S. 68, 74 (1965), quoting *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129, 134 (1936). Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10 (b). For the reasons stated above, we think the Commission's original interpretation of Rule 10b-5 was compelled by the language and history of § 10 (b) and related sections of the Acts. See, e. g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1305 (CA2 1973); *SEC v. Texas Gulf Sulphur Co.*, *supra*, at 868; 3 Loss Securities Regulation 1766 (2d ed. 1961); 6 *id.*, at 3883-3885 (Supp. 1969). In short, where a statute speaks so specifically in terms of manipulation and deception, and of implementing devices or contrivances—the commonly understood terminology of intentional wrongdoing—and where its his-

and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3230 (May 21, 1942).

That same year, in its Annual Report, the Commission again stated that the purpose of the rule was to protect investors against "fraud":

"During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities, while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers." 8 SEC Ann. Rep. 10 (1942).

tory reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.<sup>26</sup>

### III

Recognizing that as a precondition to the imposition of civil liability § 10 (b) and Rule 10b-5 might be held

<sup>26</sup> As we find the language and history of § 10 (b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy," set forth by the parties, that may have influenced the lawmakers in their formulation of the statute. We do note that the standard urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts. Last Term, in *Blue Chip Stamps*, 421 U. S., at 747-748, the Court pertinently observed:

"While much of the development of the law of deceit has been the elimination of artificial barriers to recover on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441, Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate cause':

"The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of the duty that exposes to these consequences.' *Id.*, at 179-180, 174 N. E., at 444."

This case, on its facts, illustrates the extreme reach of the standard urged by respondents. As investors in transactions initiated by Nay, not First Securities, they were not foreseeable users of the financial statements prepared by Ernst & Ernst. Respondents conceded that they did not rely on either these financial statements or Ernst & Ernst's certificate of opinion. See n. 9. The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands. Acceptance of respondents' view would extend the "hazards" of rendering expert advice under the Acts to new frontiers, raising serious policy questions not yet addressed by Congress.

2



to require proof of more than negligent misfeasance by Ernst & Ernst, respondents further contend that whatever standard is adopted, the case should be remanded for trial. Throughout the lengthy history of this case respondents have proceeded on a theory of liability premised on negligence, specifically disclaiming that Ernst & Ernst had engaged in fraud or intentional misconduct.<sup>21</sup> In these circumstances, we think it inappropriate to remand the action for further proceedings.

The judgment of the Court of Appeals is

*Reversed.*

MR. JUSTICE STEVENS took no part in the consideration or decision of this case.

---

<sup>21</sup> See 503 F. 2d, at 1104, 1119; n. 5, *supra*.

CHAMBERS DRAFT

SUPREME COURT OF THE UNITED STATES

No. 74-1042

Ernst & Ernst, Petitioner,	On Writ of Certiorari to the United States Court of Ap- peals for the Seventh Cir- cuit.
v.	
Olga Hochfelder et al.	

[March —, 1976]

MR. JUSTICE POWELL delivered the opinion of the Court.

The issue in this case is whether an action for civil damages may lie under § 10 (b) of the Securities Exchange Act of 1934 (the 1934 Act), 48 Stat. 891, 15 U. S. C. § 78j (b), and Securities and Exchange Commission Rule 10b-5, 17 CFR § 240.10b-5, in the absence of an intent to deceive, manipulate, or defraud on the part of the defendant.

I

Petitioner, Ernst & Ernst, is an accounting firm. From 1946 through 1967 it was retained by First Securities Company of Chicago (First Securities), a small brokerage firm and member of the Midwest Stock Exchange and the National Association of Securities Dealers, to perform periodic audits of the firm's books and records. In connection with these audits Ernst & Ernst prepared for filing with the Securities and Exchange Commission (the Commission) the annual report for First Securities, as required by § 17 (a) of the 1934 Act, 15 U. S. C. § 788 (a).<sup>1</sup> It also prepared for First Securities responses

<sup>1</sup> Section 17 (a) requires that securities brokers or dealers "make . . . and preserve . . . such accounts . . . books, and other



to the financial questionnaires of the Midwest Stock Exchange.

Respondents were customers of First Securities who invested in a fraudulent securities scheme perpetrated by Leston B. Nay, president of the firm and owner of 92% of its stock. Nay induced the respondents to invest funds in "escrow" accounts that he represented would yield a high rate of return. Respondents did so from 1942 through 1966, with the majority of the transactions occurring in the 1950's. The escrow fund transactions were not in the customary form of dealings between First Securities and its customers. Typically, the respondents sold legitimate securities through First Securities to obtain funds to invest in the escrow accounts. They then drew their personal checks payable to Nay or the bank for his account. No such escrow accounts were reflected on the books and records of First Securities, and none was shown on its periodic accounting to respondents. Nor were they included in First Securities' filings with the Commission or the Exchange. In fact, there were no escrow accounts as Nay converted re-

records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." During the period relevant here, Commission Rule 17a-5, 17 CFR § 240.17a-5, required that the reports of financial condition include a certificate stating "clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." See SEC Release No. 3338 (Nov. 28, 1948), X-17A-5 (h). The rule required Ernst & Ernst to state in its certificate, *inter alia*, "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances" and provided that nothing should "be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit for the purpose of expressing the opinions" required by the rule.

spondents' funds to his own use immediately upon receipt.

This fraud came to light in 1968 when Nay committed suicide, leaving a note describing First Securities as bankrupt and the escrow investments as "spurious." Respondents subsequently filed this action<sup>2</sup> for damages against Ernst & Ernst<sup>3</sup> in the United States District Court for the Northern District of Illinois under § 10 (b) of the 1934 Act. The complaint charged that Nay's escrow scheme violated § 10 (b) and Rule 10b-5 of the Commission,<sup>4</sup> and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct a proper audit of First Securities. As revealed through discovery, respondent's cause of action rested on a theory of negligent misfeasance. The premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm

<sup>2</sup> Two separate, but substantially identical, complaints initially were filed by different groups of respondents. Subsequently the respondents jointly filed a First Amended Complaint. The two cases were treated by the District Court as if they were consolidated and were consolidated formally on appeal.

<sup>3</sup> The first count of the complaint was directed against the Midwest Stock Exchange, charging that through its act and omissions it had aided and abetted Nay's fraud. Summary judgment in favor of the Exchange was affirmed on appeal, *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d 384 (CA7), cert. denied, 419 U. S. 875 (1974).

<sup>4</sup> Immediately after Nay's suicide the Commission commenced receivership proceedings as to First Securities. In those proceedings all of the respondents except two asserted claims based on the fraudulent escrow accounts. These claims ultimately were upheld in *SEC v. First Securities Co.*, 463 F. 2d 981, 986 (CA7 1972), cert. denied, 409 U. S. 880 (1973), where the court held that Nay's conduct violated § 10 (b) and Rule 10b-5, and that First Securities was liable for Nay's fraud as an aider and abettor. The question of Ernst & Ernst's liability was not considered in that case.



said to prevent an effective audit. The practice principally relied on was Nay's rule that only he could open mail addressed to him at First Securities or addressed to First Securities to his attention, even if it arrived in his absence. Respondents contended that if Ernst & Ernst had conducted a proper audit, it would have discovered this "mail rule." The existence of the rule then would have been disclosed in reports to the Midwest Stock Exchange and to the Commission, and this would have led to an investigation of Nay that would have revealed the fraudulent scheme. Respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.<sup>4</sup>

After extensive discovery the District Court granted Ernst & Ernst's motion for summary judgment and dismissed the action. The court rejected Ernst & Ernst's contention that a cause of action for aiding and abetting a securities fraud could not be maintained under § 10 (b) or Rule 10b-5 merely on allegations of negligence. It concluded, however, that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards.<sup>5</sup>

---

<sup>4</sup> In their response to interrogatories in the District Court respondents conceded that "[w]e do not accuse Ernst & Ernst of deliberate, intentional fraud," merely with "inexcusable negligence." App. 81.

<sup>5</sup> The District Court also held that respondents' action was barred by the doctrine of equitable estoppel and the applicable state statute of limitations of three years. See n. 27, *infra*. As customers of First Securities some of the respondents were sent confirmation forms as required under § 17 (a) and Rule 17a-5 requesting that they verify the accuracy of the statements and notify Ernst & Ernst as to any exceptions. Although the confirmation forms contained no reference to the escrow accounts, Ernst & Ernst were not notified of this fact. The last audit of First Securities by Ernst & Ernst

The Court of Appeals for the Seventh Circuit reversed and remanded. 503 F. 2d 1110 (1974). That court held that one who breaches a duty of inquiry and disclosure owed another can be liable in damages for aiding and abetting a third party's violation of Rule 10-b upon demonstrating that but for the breach the fraud would have been discovered or prevented. *Id.*, at 1104.<sup>7</sup> The court reasoned that Ernst & Ernst had a common-law and statutory duty of inquiry as to the adequacy of First Securities' internal control system because it had contracted to audit First Securities and to prepare for filing with the Commission the annual report of its financial

was completed in December 1967 and the first complaint in this action was not filed until February 1971.

<sup>7</sup> In support of this holding, the Court of Appeals cited its decision in *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d 364 (CA7 1974), where it stated that a claim for aiding and abetting a securities fraud solely by inaction could be maintained under Rule 10b-5. In such case the plaintiff must show "that the party charged with aiding and abetting had knowledge of or, but for the breach of a duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." *Id.*, at 374. The court explained in this case that these "elements constitute a flexible standard of liability which should be amplified according to the peculiarities of each case." 503 F. 2d, at 1104. In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10 (b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule, nor the elements necessary to establish such a cause of action. See, e. g., *Brennan v. Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (ND Ind. 1966), 286 F. Supp. 702 (ND Ind. 1968), *aff'd.* 417 F. 2d 147 (CA7 1969), *cert. denied*, 397 U. S. 989 (1970) (defendant held liable for giving active and knowing assistance to a third party engaged in violations of the securities laws). See generally Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597, 820-845 (1972).



condition required under § 17 of the 1934 Act and Rule 17a-5, 17 CFR § 240, 17a-5.<sup>9</sup> The Court further reasoned that respondents were beneficiaries of the statutory duty to inquire,<sup>10</sup> and the related duty to disclose any material irregularities that were discovered. *Id.*, at 1105-1111. The court concluded that there were genuine issues of fact as to whether Ernst & Ernst's failure to discover and comment upon Nay's mail rule<sup>10</sup> constituted a breach of its duties of inquiry and disclosure, *id.*, at 1111, and whether inquiry and disclosure

<sup>9</sup> See n. 1, *supra*.

<sup>10</sup> The court concluded that the duty of inquiry imposed on Ernst & Ernst under § 17 (a) was "grounded on a concern for the protection of investors such as [respondents]," without reaching the question whether the statute imposed a "direct duty" to the respondents. 503 F. 2d, at 1105. The court recognized that Ernst & Ernst owed no common-law duty of inquiry to respondents arising from its contract with First Securities since Ernst & Ernst did not specifically foresee that respondents limited class might suffer from a negligent audit, compare *Glanzer v. Shepard*, 233 N. Y. 236, 135 N. E. 275 (1922), with *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931), see, e. g., *R. I. Hospital Trust Nat'l Bank v. Swartz*, 455 F. 2d 847, 851 (CA4 1972). Indeed, respondents conceded that they did not rely on the financial statements and reports prepared by Ernst & Ernst or on its certificate of opinion. 503 F. 2d, at 1107.

<sup>11</sup> In their briefs respondents allude to several other alleged failings by Ernst & Ernst in its audit of First Securities, principally its failure to inquire into the collectibility of certain loans by First Securities to Nay and its failure to follow up on a 1965 memorandum that characterized First Securities' overall system of internal control as weak because of the centralization of functions in the cashier. The Court of Appeals mentioned none of these alleged deficiencies in its opinion in this case, although it did discuss some of them in its opinion in *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d, at 370-371, holding that they were insufficient to put the Exchange on notice that further inquiry into First Securities' financial affairs was required.

would have led to the discovery or prevention of Nay's fraud. *Id.*, at 1115.<sup>11</sup>

We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10 (b) and Rule 10b-5 in the absence of any allegation of scienter—an intent to deceive, manipulate, or defraud.<sup>12</sup> 421 U. S. 909 (1975). We conclude that it will not and therefore we reverse.<sup>13</sup>

<sup>11</sup> The Court of Appeals also reversed the District Court's holding with respect to Ernst & Ernst's equitable estoppel and statute of limitations defenses. See n. 6, *supra*. In view of our disposition of the case we need not address the issues raised by these defenses.

<sup>12</sup> Although the verbal formulations of the standard to be applied have varied, several courts of appeals in substance have held that negligence alone is sufficient for civil liability under § 10 (b) and Rule 10b-5. See, e. g., *White v. Abrams*, 495 F. 2d 724 (CA9 1974) (flexible duty standard); *Myzel v. Fields*, 386 F. 2d 718, 735 (CA8 1967), cert. denied, 390 U. S. 951 (1968) (negligent misfeasance sufficient for liability); *Kohler v. Kohler Co.*, 319 F. 2d 634 (CA7 1963) (knowledge not required). Other courts of appeals have held that some type of "scienter"—i. e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud—is necessary in such an action. See, e. g., *Clegg v. Conk*, 507 F. 2d 1351, 1361-1362 (CA10 1974), cert. denied, 422 U. S. 1007 (1975) (something more than ordinary negligence); *Lanza v. Drezzel & Co.*, 479 F. 2d 1277, 1306 (CA2 1973) ("willful or reckless disregard" of the truth). But few of the decisions announcing that some form of negligence suffices for civil liability under § 10 (b) and Rule 10b-5 have involved only negligent conduct. *Smallwood v. Pearl Brewing Co.*, 489 F. 2d 579, 606 (CA5 1974), cert. denied, 419 U. S. 879 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 286 (CA3 1972) (Adams, J., concurring); *Bucklo*, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 568-570 (1972).

In this opinion the term "scienter" refers to a mental state embracing an intent to deceive, manipulate, or defraud. In certain areas of the law reckless disregard of the truth is considered equivalent to knowledge for purposes of imposing liability for some act. We need not here address the question whether, in some circum-

[Footnote 13 is on p. 8]



## II

Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929. The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended 15 U. S. C. § 77a *et seq.*, was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H. R. Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges. See S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934). Although the Acts contain numerous carefully drawn express civil remedies and criminal penalties, Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the 1934 Act Congress created the Commission, providing it

---

stances, reckless behavior is sufficient for civil liability under § 10 (b) and Rule 10b-5.

<sup>12</sup> Respondents contend that Ernst & Ernst owed them a direct duty under § 17 (a) and Rule 17a-5 of the 1934 Act to conduct a proper audit of First Securities and that they may premise a private cause of action against Ernst & Ernst for violation of that duty. Respondents' original cause of action, however, was premised solely on alleged aiding and abetting violation of § 10 (b) and Rule 10b-5. During the lengthy history of this litigation they apparently made no motion to amend their original complaint to include a damage action under § 17 (a) and Rule 17a-5. We do not think that respondents should be permitted to raise this new cause of action for the first time in this Court.

with an arsenal of flexible enforcement powers. See, e. g., 1933 Act §§ 8, 19, 20, 48 Stat. 79, 85, 86, as amended, 15 U. S. C. §§ 77h, 77s, 77t; 1934 Act §§ 9, 19, 21, 48 Stat. 889, 898, 899, as amended, 15 U. S. C. §§ 78i, 78s, 78u.

Section 10 of the 1934 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." 15 U. S. C. § 78j. In 1942, acting pursuant to the power conferred by § 10 (b), the Commission promulgated Rule 10b-5, which provides:

"Employment of manipulative and deceptive devices

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, "(1) to employ any device, scheme, or artifice to defraud,

"(2) 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

"(3) 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."

Although § 10 (b) does not by its terms create an express civil remedy for its violation, and there is no



indication that Congress,<sup>14</sup> or the Commission when adopting Rule 10b-5,<sup>15</sup> contemplated such a remedy, the existence of a private cause of action for violations of the Rule is now well established. *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U. S. 128, 150-154 (1972); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U. S. 6, 13 n. 9 (1971). During the 30-year period since a private cause of action was first implied under § 10 (b) and Rule 10b-5,<sup>16</sup> a substantial body of case law and commentary has developed as to its elements. Courts and commentators long have differed as to whether scienter is a necessary element of such a cause of action, or whether negligent conduct alone is sufficient.<sup>17</sup> In addressing this question, we turn first to the language of § 10 (b), for the "starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps*, *supra*, at 756 (Powell, J., concurring). *E. g.*, *FTC v. Bunte Brothers*, 312 U. S. 349, 350 (1941).

<sup>14</sup> See, *e. g.*, S. Rep. No. 792, 73d Cong., 2d Sess., pp. 5-6 (1934); Note, Implied Liability Under the Securities Exchange Act, 61 Harv. L. Rev. 859, 861 (1948).

<sup>15</sup> See, *e. g.*, *Birnbaum v. Newport Steel Corp.*, 193 F. 2d 461, 483 (CA2), cert. denied, 343 U. S. 956 (1952); 3 Loss, Securities Regulation 1469 n. 87 (2d ed. 1961).

<sup>16</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (1946).

<sup>17</sup> See cases cited in n. 12, *supra*. Compare, *e. g.*, Comment, Scienter and Rule 10b-5, 69 Col. L. Rev. 1057, 1080-1081 (1969); Note, Negligent Misrepresentations under Rule 10b-5, 32 Chi. L. Rev. 824, 835-836 (1965); Note, 82 Harv. L. Rev. 938, 947 (1969); Note, Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L. J. 658, 682-689 (1965), with, *e. g.*, 3 Loss, *supra*, at 1766; 6 *id.*, at 3883-3885 (Supp. 1969).

## A

Section 10 (b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10 (b) was intended to proscribe knowing or intentional conduct. See *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 868 (CA2 1968) (Friendly, J., concurring), cert. denied *sub nom. Kline v. SEC*, 394 U. S. 976 (1969); Loss, Summary Remarks, 30 Bus. Lawyer 163, 165 (1975). See also *Kohn v. American Metal Climax*, 458 F. 2d 255, 280 (CA3 1972) (Adams, J., concurring).

In its *amicus curiae* brief, however, the Commission contends that nothing in the language "any manipulative device or contrivance" limits its operation to knowing and intentional practices.<sup>12</sup> In support of its view, the Commission cites the overall congressional purpose

<sup>12</sup> The Commission, however, would not permit recovery upon proof of negligence in all cases. In light of the limitations that Congress has placed on the express civil remedies in the 1933 and 1934 Acts, see pp. ———, *infra*, the Commission would limit the circumstances in which civil liability could be imposed for negligent violation of Rule 10b-5 to situations in which (i) "the defendant knew or reasonably could foresee that the plaintiff would rely on his conduct, (ii) the plaintiff did in fact so rely, and (iii) the amount of the plaintiff's damages caused by the defendant's conduct was definite and ascertainable." Brief of *Amicus Curiae* 23-33. The Commission concludes that the present record does not establish these conditions for civil liability since respondents in fact did not rely on Ernst & Ernst's audits, the financial statements of First Securities could not have been reasonably foreseen as likely to induce respondents to invest in the escrow accounts, and the amount of respondents' damages was unascertainable. *Id.*, 33-36. Respondents accept the Commission's analysis of the operative language of the statute and Rule, but reject these additional requirements for recovery for negligent violations.



in the 1933 and 1934 Acts to protect investors against false and deceptive practices that may injure them. *Affiliated Ute Citizens v. United States*, 406 U. S., at 151; *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U. S., at 11-12; *J. I. Case Co. v. Borak*, 377 U. S. 426, 433 (1971); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1963). The Commission then reasons that since the "effect" upon investors of given conduct is the same whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission is unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning. See, e. g., *Addision v. Holly Hill Co.*, 32 U. S. 607, 617-618 (1944).<sup>10</sup> The Commission's argument simply ignores the use of the words "device" or "contrivance," terms that make unmistakable a congressional intent to proscribe a type of con-

<sup>10</sup> "We should of course be faithful to the meaning of a statute. But after all Congress expresses its meaning by words. If legislative policy is couched in vague language, easily susceptible of one meaning as well as another in the common speech of men, we should not stifle a policy by a . . . grudging process of construction. To let words draw on some purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another . . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him." 322 U. S., at 617-618. See Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Col. L. Rev. 527, 536-537 (1947).

duct quite different from negligence.<sup>20</sup> Few concepts in the law are more familiar than that of negligence. One must assume that if Congress had intended to extend the reach of § 10 (b) to embrace negligent conduct it would have said so in conventional, commonly accepted terms.

In addition to relying upon the Commission's argument with respect to the operative language of the statute, respondents contend that since we are dealing with "remedial legislation," *Tcherepnin v. Knight*, 389 U. S. 332, 336 (1967), it must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens v. United States*, 406 U. S., at 151. This argument assumes that "remedial purposes" of the Act embrace as a minimum a negligence standard of liability. But in seeking to accomplish its broad remedial goals, Congress did not elect a single or uniform standard of civil liability even as to express civil remedies. In some circumstances and with respect to certain classes of defendants, Congress did create express liability predicated upon a failure to exercise reasonable care, e. g., 1933 Act § 11 (b) (liability of persons such as accountants or lawyers for misleading statements in portions of registrations statements for which they are responsible). In other situations good faith is an absolute defense, 1934 Act § 18, 15 U. S. C. § 78r

<sup>20</sup> Webster's Int'l Dictionary (2d ed. 1934) defines "device": "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice" and "contrivance" in pertinent part as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "To devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . ." The Commission also ignores the use of the terms "[t]o use or employ," language that is supportive of the view that Congress did not intend § 10 (b) to embrace negligent conduct.



(misleading statements in any document filed pursuant to the Act), while in other circumstances Congress created express liability regardless of the defendant's fault, 1933 Act § 11 (issuer liability for misleading statements in the registration statement).

It is thus evident that Congress imposed express civil liability in the 1933 and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Act must therefore rest primarily on the language of that section. Where, as here, we deal with a judicially implied liability, the statutory language certainly is no less important. In view of the language of § 10 (b) which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its context, *United States v. Oregon*, 366 U. S. 643, 648 (1961); *Packard Motor Car Co. v. NLRB*, 330 U. S. 485, 492 (1947), further inquiry may be unnecessary. We turn now, nevertheless, to the legislative history of the 1934 Act to ascertain whether there is support for the meaning attributed to § 10 (b) by the Commission and respondents.

#### B

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, that history supports our conclusion that § 10 (b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.

The original version of what would develop into the 1934 Act was contained in identical bills introduced by Senator Fletcher and Representative Rayburn. S. 2693, 73d Cong., 2d Sess. (1934). H. R. 7852, 73d Cong., 2d

Sess. (1934). Section 9 (c) of the bills, from which present § 10 (b) evolved, proscribed as unlawful the use of "any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors." The other subsections of proposed § 9 listed specific practices that Congress empowered the Commission to regulate through its rulemaking power. See §§ 9 (a) ("short sale"), (b) ("stop-loss order"). Soon after the hearings on the House bill were held, a substitute bill was introduced which abbreviated and modified § 9 (c)'s operative language to read "any manipulative device or contrivance." S. 3420, 73d Cong., 2d Sess., 9 (c) (1934); H. R. 7852, 73d Cong., 2d Sess., 9 (c) (1934). Still a third bill, retaining the Commission's power to regulate the specific practices enumerated in the prior bills, and omitting all reference to the Commission's authority to prescribe rules concerning manipulative or deceptive devices in general, was introduced and passed in the House. H. R. 9323, 73d Cong., 2d Sess. (1934). The final language of § 10 is a modified version of a Senate amendment to this last House bill. See H. R. Rep. No. 1838, 73d Cong., 2d Sess., 32-33 (1934).

Neither the intended scope of § 10 (b) nor the reasons for the changes in its operative language are explicitly revealed in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation. There is no indication, however, that § 10 (b) was intended to proscribe conduct not involving scienter. The Senate Report discusses generally the various abuses that precipitated the need for the legislation and the inadequacy of self-regulation by the stock exchanges.

The Report then analyzes the component provisions



of the statute, but does not parse § 10. The only specific reference to § 10 in this discussion is the following:

"In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10 and 16." S. Rep. 792, 73d Cong., 2d Sess., 6 (1934).

In the portion of the general analysis section of the Report entitled "Manipulative Practices," however, there is a discussion of specific practices that were considered so inimical to the public interest as to be expressly prohibited, such as "wash" sales and "matched" orders,<sup>21</sup> and of other practices, such as stabilization of security prices and grants of options, that might in some cases serve legitimate purposes. These latter practices were left to regulation by the Commission. Significantly, we think, in discussing these practices, there was no indication that any type of criminal or civil liability was to attach in the absence of scienter. For example, in discussing the potential abuses resulting from the use of options, the Report indicated that self-regulation by a

<sup>21</sup> Wash sales are transactions involving no change in beneficial ownership. Matched orders are orders for the purchase/sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security. Section 9(a)(1) of the 1934 Act, 15 U. S. C. § 78(a)(1), proscribes wash sales and matched orders when effectuated "[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange or . . . the market for any such security." See *In re J. A. Latimer & Co.*, 38 S. E. C. 790 (1958); *In re Thornton & Co.*, 28 S. E. C. 208 (1948).

securities exchange had proved inadequate because members might employ nonmembers, not bound by its rules, to execute transactions. *Id.*, 9. In commenting on the express civil liabilities provided in the 1934 Act, the Report explains:

"... the bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in good faith." *Id.*, at 12-13 (emphasis supplied).

The Senate Report thus reveals a congressional intent to prevent "manipulative and deceptive practices . . . which fulfill no useful function" and to create a private action for damages stemming from "illicit practices," where the defendant has not acted in good faith. There is no indication that Congress intended anyone to be made an insurer against potentially misleading conduct or misstatement unless he acted otherwise than in good faith.

The extensive hearings that preceded passage of the 1934 Act similarly touched only briefly on § 10, and most of the discussion was devoted to the enumerated devices now proscribed in § 10 (a). The most relevant exposition of the provision that was to become § 10 (b) was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:

"Subsection (c) [§ 9 (c) of H. R. 7852—later § 10



(b)] says, 'Thou shalt not devise any other cunning devices.' . . .

"Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."

Hearings on H. R. 7852 and R. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934). This brief explanation of § 10 (b) by the spokesman for its drafters is significant. The section was described rightly as a "catch-all" clause to enable the Commission "to deal with new manipulative [or cunning] devices." It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions. Use of the word "manipulative" is especially significant. It is virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.<sup>22</sup> Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing manipulative or cunning conduct to include negligence.<sup>23</sup>

<sup>22</sup> See Webster's Int'l Dictionary (2d ed. 1934): "manipulate": "... to manage or treat artfully or fraudulently; as to *manipulate* accounts . . . 4. *Exchanges*. To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig."

<sup>23</sup> In support of its position the Commission cites a statement by Corcoran in the Senate hearings that "in modern society there are many things you have to make crimes which are sheer matters of negligence" and "intent is not necessary for every crime." Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., 6509-6510 (1934). The comment, taken in context, sheds no light on the meaning of § 10 (b).

## C

The 1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities. See *Blue Chip Stamps*, *supra*, at 727-730. As the Court indicated in *SEC v. National Securities, Inc.*, 393 U. S. 453 (1969), "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen." Recognizing this, respondent and

The question had been raised whether criminal violations could arise under § 8 of S. 2693, 73d Cong., 2d Sess., which became § 9 of the 1934 Act, in the absence of specific intent to influence security prices for personal gain. Corcoran's remarks, however, were not addressed to the scope of § 8, but were general observations concerning activity society might proscribe under criminal law. Ferdinand Pecora, counsel to the committee, described the draft language as "[e]xcluding from its scope an act that is not done with any ulterior motives or purposes, as set forth in the act." *Id.*, 6510. Moreover, prior to the passage of the 1934 Act, § 8 was amended to require willful participation as a prerequisite to civil liability for violations. Compare § 9(e) of the 1934 Act with § 8 (c) of S. 2693.

The Commission further relies on objections to a draft version of § 10 (b)—§ 9 (c) of S. 2693 and H. R. 7852, see pp. ———, *supra*—raised by representatives of the securities industry in the House and Senate hearings. They warned that the language was so vague that the Commission might outlaw anything. *E. g.*, Hearings on Stock Exchange Practices, *supra*, at 6988; Hearings on H. R. 7852 and H. R. 8720, House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934), 258. Remarks of this kind made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill, are entitled to little weight. See, *e. g.*, *United States v. United Mine Workers*, 330 U. S. 258, 276-277 (1947); *United States v. Wrightwood Dairy Co.*, 315 U. S. 110, 125 (1942). This is especially so with regard to the statements of legislative opponents who "[i]n their zeal to defeat a bill . . . understandably tend to overstate its reach." *NLRB v. Fruit Packers*, 377 U. S. 58, 66 (1964). See *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U. S. 384, 394-395 (1951).



the Commission contrast § 10 (b) to other sections of the Acts to support their contention that civil liability may be imposed upon proof of negligent conduct. We think they misconceive the significance of the other provisions of the Act, in which we find evidence supportive of a requirement that an element of scienter be proved.

The Commission argues that Congress has been explicit in requiring willful conduct when that was the standard of fault intended, citing § 9 of the 1934 Act, 15 U. S. C. § 78, which generally proscribes manipulation of securities prices. Sections 9 (a)(1) and (2), for example, respectively prohibit manipulation of security prices "[f]or the purpose of creating a false or misleading appearance of actual trading in any security . . . or . . . with respect to the market for any such security," and "for the purpose of inducing the purchase or sale of such security by others." See also § 9 (a)(4). Section 9 (e) then imposes upon "[a]ny person who willfully participates in any act or transaction in violation of" other provisions of § 9 liability to anyone who purchased or sold a security at a price affected by the manipulative activities. From this the Commission concludes that since § 10 (b) is not by its terms explicitly restricted to willful, knowing, or purposeful conduct, it should not be construed in all cases to require more than negligent action or inaction as a precondition for civil liability.

The structure of the Acts does not support the Commission's argument. In each instance that Congress created express civil liability in both Acts it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake. See 1933 Act, §§ 11, 12, 15, 15 U. S. C. §§ 77k, 77l, 77o; 1934 Act §§ 9, 16, 18, 20, *id.*, §§ 78i, 78p 78r, 78t. For example, § 11 of the 1933 Act unambiguously creates a private action for damages when a

registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading. The issuer of the securities is held absolutely liable for any damages, within the limits specified by § 11 (e), resulting from such misstatement or omission. But experts such as accountants who have prepared portions of the registration statement are accorded a "due diligence" defense. In effect, this is a negligence standard. An expert may avoid civil liability with respect to the portions of the registration statement for which he is responsible by showing that "after reasonable investigation" he had "reasonable ground[s] to believe" that the statements for which he was responsible were true and there was no omission of a material fact.<sup>24</sup> § 11 (b)(3)(B)(i). See, e. g., *Escott v. Barchris Corp.*, 283 F. Supp. 643, 697-703 (SDNY 1968). The express recognition of a cause of action premised on negligent behavior in § 11 stands in sharp contrast to the language of § 10 (b), and significantly undercuts the Commission's argument.

Equally significant, while specifying negligence as a standard of fault in some circumstances under the 1933 Act, see §§ 11, 12 (2), 15, 15 U. S. C. §§ 77k, 77l, 77o,<sup>25</sup>

<sup>24</sup> Other individuals who sign the registration statement, directors of the issuer, and the underwriter of the securities similarly are accorded a complete defense against civil liability based on the exercise of reasonable investigation and a reasonable belief that the registration statement was not misleading. §§ 11 (b)(3)(A), (C), (D); (c). See, e. g., *Fait v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 575-583 (EDNY 1971) (underwriters, but not officer-directors, established their due diligence defense). See generally R. Jennings & H. Marsh, *Securities Regulation* 1018-1027 (3d ed. 1972), and sources cited therein; Folk, *Civil Liabilities under the Federal Securities Acts: The Barchris Case*, 55 Va. L. Rev. 199 (1969).

<sup>25</sup> Section 12 (2) creates potential civil liability for a seller of securities in favor of the purchaser for misleading statements or



Congress indicated no role for such a standard in the 1934 Act. Each of the express liability provisions of the 1934 Act, except those directed to specific classes of individuals such as directors, officers, or 10% beneficial holders of securities, see § 16 (b), 15 U. S. C. § 78p,<sup>20</sup> contains a state of mind requirement for civil liability requiring something more than negligence. Section 9 proscribes the manipulation of securities on national securities exchanges and creates potential civil liability for any person who "willfully participates" in such conduct. § 9 (e). Section 18 creates potential civil liability for misleading statements filed with the Commission, but provides the defendant with the defense that "he acted in good faith and had no knowledge that such statement was false or misleading." 15 U. S. C. § 78r. And § 20, 15 U. S. C. § 78t, which imposes liability upon "controlling persons" for violations of the Act by persons whom they control, exculpates a defendant who "acted in good faith and did not . . . induce the act . . . constituting the

---

omissions in connection with the transaction. The seller is exculpated if he proves that he did not know, or in the exercise of reasonable care, could not have known of the untruth or omission. Section 15 of the 1933 Act, as amended by § 208 of the 1934 Act, makes persons who "control" any person liable under § 11 or § 12 liable jointly and severally to the same extent as the controlled person, unless he "had no knowledge of or reasonable grounds to believe in the existence of facts by reasons of which the liability of the controlled person is alleged to exist." 15 U. S. C. § 77o. See Act of June 6, 1934, Pub. L. No. 291, c. 404, § 208, 48 Stat. 908.

<sup>20</sup> Section 16 (b) provides that a corporation may recapture for itself the profits realized on a purchase and sale, or sale and purchase, of its securities within six months by a director, officer, or beneficial owner of more than 10% of any class of the corporation's equity securities. See *Foremost-McKesson, Inc. v. Provident Securities Co.*, — U. S. — (1976); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U. S. 582 (1973); *Reliance Electric Co. v. Emerson Electric Co.*, 404 U. S. 418 (1972).

violation. . . ." In *Blue Chip Stamps, supra*, at 736, we noted the anomaly of imputing to Congress an intention "to expand . . . a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action" in the provisions of these Acts. The result urged here by respondents would be no less anomalous.

Finally, the express civil remedies in the 1933 Act allowing recovery for negligent conduct are subject to significant procedural restrictions not applicable under § 10 (b). Section 11 (e) of the 1933 Act, for example, authorizes the court to require a plaintiff bringing a suit under § 11, § 12 (2), or § 15 thereof to post a bond for costs, including attorneys' fees. Section 13 specifies a statute of limitations of one year from the violation, or three years from the offer or sale, applicable to actions brought under § 11, § 12 (2), or § 15. It also is significant that simultaneously with the adoption of the 1934 Act, Congress tightened the restrictions on § 11 and § 12 actions by amendment of the 1933 Act. Prior thereto, § 11 contained no provision for payment of costs. 48 Stat. 891. See Act of June 6, 1934, Pub. L. No. 291, c. 404, § 206 (c), 48 Stat. 907. The amendments also substantially shortened the statute of limitations provided by § 13 of the 1933 Act. Compare 1933 Act § 13, 48 Stat. 84, with 15 U. S. C. § 77m. See 1934 Act, § 207, 48 Stat. 908.<sup>27</sup> Absent substantial evidence in the legislative history to the contrary—and there is none—we are unwilling to assume that the judicially created private

<sup>27</sup> Since no statute of limitations is provided for civil actions under § 10 (b), as in other cases of judicially implied remedies, the law of limitations of the forum state is followed. See *Holmberg v. Armbricht*, 327 U. S. 392, 395 (1946), and cases cited therein. Although it is not always certain which state statute of limitations should be followed, such statutes of limitations usually are longer than the period provided under § 13. 3 Loss, *supra*, at 1773-1774.



damage remedy under § 10 (b) can be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Except for suits against issuers of securities, which are held absolutely liable for damages resulting from misleading registration statements, such an assumption would nullify the effectiveness of the carefully drawn restrictions on express private damages actions that Congress provided in the 1933 Act and the 1934 Amendments.<sup>28</sup> See, e. g., *Fischman v. Raytheon Manufacturing Co.*, 188 F. 2d 283 (CA2 1951); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 867-868 (Friendly, J., concurring); *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123, 124 (SD Pa. 1948); 3 Loss, *supra*, at 1787-1788; Jennings & Marsh, *Securities Regulation* (3d ed. 1972).

## D

We have addressed, to this point, primarily the language and history of § 10 (b). The Commission contends, however, that subsections (2) and (3) of Rule 10b-5 are cast in language which—if standing alone—could encompass both intentional and negligent behavior. These subsections respectively provide that it is unlawful “[t]o make any untrue statement of a material fact necessary in order to make the statements made in

<sup>28</sup> Congress regarded these restrictions on private damage actions as significant. In introducing Title II of the 1934 Act, Senator Fletcher indicated that the amendment to § 11 (e) of the 1933 Act, providing for potential payment of costs, including attorneys' fees “is the most important [amendment] of all.” 78 Cong. Rec. 8869. One of its purposes was to deter actions brought solely for their potential settlement value. See *Blue Chip Stamps, supra*, at 740-741. This deterrent is lacking in the § 10 (b) context, in which a district court's power to award attorneys' fees is sharply circumscribed. See *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U. S. 240 (1975) (“bad faith” requirement); *F. D. Rich Co. v. Industrial Lumber Co.*, 417 U. S. 116, 129 (1974).

light of the circumstances under which they were made, not misleading . . ." or "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . ." Viewed in isolation the language of subsection (2), and arguably that of subsection (3), could be read as proscribing any type of material misstatement or omission, or course of conduct, that has the effect of defrauding investors, whether negligently caused or otherwise.

We note first that such a reading cannot be harmonized with the administrative history of the Rule, a history making clear that when adopted the Commission intended it to apply only to activities that involved scienter.<sup>20</sup> More important, Rule 10b-5 was adopted

<sup>20</sup> Apparently the Rule was a hastily drafted response to a situation involving clear evidence of intentional misconduct. The Commission's Regional Administrator in Boston had reported to the Director of the Trading and Exchange Division that the president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at the resultant depressed prices, when in fact the business was doing exceptionally well. The Rule was drafted and approved on the day this report was received. See Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (remarks of Milton Freeman, one of Rule's co-drafters); *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S., at 767 (BLACKMUN, J., dissenting). Although adopted pursuant to § 10 (b), the language of the Rule appears to have been derived in significant part from § 17 of the 1933 Act, 15 U. S. C. § 78q, e. g., *ibid.*; *SEC v. Texas Gulf Sulfur Co.*, 401 F. 2d, at 867 (Friendly, J., concurring). There is no indication in the administrative history of the Rule that any of the subsections was intended to proscribe conduct not involving scienter. Indeed the Commission's Release issued contemporaneously with the Rule explained:

"The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers



pursuant to authority granted the Commission under § 10 (b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Dixon v. United States*, 381 U. S. 68, 74 (1965), quoting *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129, 134 (1936). Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10 (b). For the reasons stated above, we think the Commission's original interpretation of Rule 10b-5 was compelled by the language and history of § 10 (b) and related sections of the Act. See, e. g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1305 (CA2 1973); *SEC v. Texas Gulf Sulphur Co.*, *supra*, at 868; 3 Loss Securities Regulation 1766 (2d ed. 1961); 6 *id.*, at 3883-3885 (Supp. 1969). In short, where a statute speaks so specifically in terms of manipulation and deception, and of implementing devices or contrivances—the commonly understood terminology of intentional wrongdoing—and where its his-

---

and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3230 (May 21, 1942).

That same year, in its Annual Report, the Commission again stated that the purpose of the rule was to protect investors against "fraud":

"During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities, while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers." 8 SEC Ann. Rep. 10 (1942).

tory reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.<sup>80</sup>

### III

Recognizing that as a precondition to the imposition of civil liability § 10 (b) and Rule 10b-5 might be held

<sup>80</sup> As we find the language and history of § 10 (b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy," set forth by the parties, that may have influenced the lawmakers in their formulation of the statute. We do note that the standard urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Act. Last Term, in *Blue Chip Stamps*, 421 U. S., at 747-748, the Court pertinently observed:

"While much of the development of the law of deceit has been the elimination of artificial barriers to recover on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441, Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate cause':

"The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of the duty that exposes to these consequences.' *Id.*, at 179-180, 174 N. E., at 444."

This case, on its facts, illustrates the extreme reach of the standard urged by respondents. As investors in transactions initiated by Nay, not First Securities, they were not foreseeable users of the financial statements prepared by Ernst & Ernst. Respondents conceded that they did not rely on either these financial statements or Ernst & Ernst's certificate of opinion. See n. 9. The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands. Acceptance of respondents' view would extend the "hazards" of rendering expert advice under the Act to new frontiers, raising serious policy questions not yet addressed by Congress.



to require proof of more than negligent misfeasance by Ernst & Ernst, respondents further contend that whatever standard is adopted, the case should be remanded for trial. Throughout the lengthy history of this case respondents have proceeded on a theory of liability premised on negligence, specifically disclaiming that Ernst & Ernst had engaged in fraud or intentional misconduct.<sup>11</sup> In these circumstances, we think it inappropriate to remand the action for further proceedings.

The judgment of the Court of Appeals is

*Reversed.*

MR. JUSTICE STEVENS took no part in the consideration or decision of this case.

---

<sup>11</sup> See 503 F. 2d, at 1104, 1119; n. 5, *supra*.

Greg Palm  
X 223

Justice Powell:

As you will see, I've made  
substantial re-arrangements  
of the text. I haven't  
changed the substance,  
however, although I've added  
some arguments & shifted  
the emphasis in part.  
Greg

2nd CHAMBERS DRAFT

## SUPREME COURT OF THE UNITED STATES

No. 74-1042

Ernst & Ernst, Petitioner,	{	On Writ of Certiorari to the United States Court of Ap- peals for the Seventh Cir- cuit.
v.		
Olga Hochfelder et al.		

[March —, 1976]

MR. JUSTICE POWELL delivered the opinion of the Court.

The issue in this case is whether an action for civil damages may lie under § 10 (b) of the Securities Exchange Act of 1934 (1934 Act), 48 Stat. 891, 15 U. S. C. § 78j (b), and Securities and Exchange Commission Rule 10b-5, 17 CFR § 240.10b-5, in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant.

### I

Petitioner, Ernst & Ernst, is an accounting firm. From 1946 through 1967 it was retained by First Securities Company of Chicago (First Securities), a small brokerage firm and member of the Midwest Stock Exchange and of the National Association of Securities Dealers, to perform periodic audits of the firm's books and records. In connection with these audits Ernst & Ernst prepared for filing with the Securities and Exchange Commission (the Commission) the annual reports required of First Securities under § 17 (a) of the 1934 Act, 15 U. S. C. § 78q (a).<sup>1</sup> It also prepared for First Securities responses

<sup>1</sup> Section 17 (a) requires that securities brokers or dealers "make . . . and preserve . . . such accounts . . . books, and other



to the financial questionnaires of the Midwest Stock Exchange (the Exchange).

Respondents were customers of First Securities who invested in a fraudulent securities scheme perpetrated by Leston B. Nay, president of the firm and owner of 92% of its stock. Nay induced the respondents to invest funds in "escrow" accounts that he represented would yield a high rate of return. Respondents did so from 1942 through 1966, with the majority of the transactions occurring in the 1950's. In fact, there were no escrow accounts as Nay converted respondents' funds to his own use immediately upon receipt. These transactions were not in the customary form of dealings between First Securities and its customers. The respondents drew their personal checks payable to Nay or the bank for his account. No such escrow accounts were reflected on the books and records of First Securities, and none was shown on its periodic accounting to respondents in connection with their other investments. Nor were they included in First Securities' filings with the Commission or the Exchange.

---

records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." During the period relevant here, Commission Rule 17a-5, 17 CFR § 240.17a-5, required that First Securities file an annual report of its financial condition that included a certificate stating "clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." See SEC Release No. 3338 (Nov. 28, 1948), X-17A-5 (h). The rule required Ernst & Ernst to state in its certificate, *inter alia*, "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances" and provided that nothing in the rule should "be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit for the purpose of expressing the opinions required" by the rule.

This fraud came to light in 1968 when Nay committed suicide, leaving a note that described First Securities as bankrupt and the escrow accounts as "spurious." Respondents subsequently filed this action<sup>2</sup> for damages against Ernst & Ernst<sup>3</sup> in the United States District Court for the Northern District of Illinois under § 10(b) of the 1934 Act. The complaint charged that Nay's escrow scheme violated § 10(b) and Commission Rule 10b-5,<sup>4</sup> and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct proper audits of First Securities. As revealed through discovery, respondent's cause of action rested on a theory of negligent misfeasance. The premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm said to prevent an effective audit. The practice principally relied on was Nay's rule that only he could open

<sup>2</sup> Two separate, but substantially identical, complaints formally were filed by different members of the present group of respondents. Subsequently the respondents jointly filed a First Amended Complaint. The two cases were treated by the District Court as if they were consolidated but were consolidated formally on appeal.

<sup>3</sup> The first count of the complaint was directed against the Exchange, charging that through its acts and omissions it had aided and abetted Nay's fraud. Summary judgment in favor of the Exchange was affirmed on appeal. *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d 364 (CA7, cert. denied, 419 U. S. 875 (1974)).

<sup>4</sup> Immediately after Nay's suicide the Commission commenced reorganization proceedings against First Securities. In these proceedings all of the respondents except two asserted claims based on the fraudulent escrow accounts. These claims ultimately were allowed in *SEC v. First Securities Co.*, 469 F. 2d 381, 386 (CA7 1972), cert. denied, 409 U. S. 880 (1973), where the court held that Nay's conduct violated § 10(b) and Rule 10b-5, and that First Securities was liable for Nay's fraud as an aider and abettor. The question of Ernst & Ernst's liability was not considered in that case.



mail addressed to him at First Securities or addressed to First Securities to his attention, even if it arrived in his absence. Respondents contended that if Ernst & Ernst had conducted a proper audit, it would have discovered this "mail rule." The existence of the rule then would have been disclosed in reports to the Exchange and to the Commission by Ernst & Ernst's reservation that the mail rule prevented an effective audit. This would have led to an investigation of Nay that would have revealed the fraudulent scheme. Respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.

After extensive discovery the District Court granted Ernst & Ernst's motion for summary judgment and dismissed the action. The court rejected Ernst & Ernst's contention that a cause of action for aiding and abetting a securities fraud could not be maintained under § 10 (b) and Rule 10b-5 merely on allegations of negligence. It concluded, however, that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards.<sup>5</sup>

<sup>5</sup>In their response to interrogatories in the District Court respondents conceded that they did "not accuse Ernst & Ernst of deliberate, intentional fraud," merely with "careless negligence." App. 81.

<sup>6</sup>The District Court also held respondent's action was barred by the doctrine of equitable estoppel and the applicable Illinois statute of limitations of three years. See n. 27, *infra*. As customers of First Securities respondents were sent confirmation forms as required under § 17 (a) and Rule 17a-5 requesting that they verify the accuracy of the statements and notify Ernst & Ernst as to any exceptions. Although the confirmation forms contained no reference to the penny accounts, Ernst & Ernst was not notified of this fact. The last audit of First Securities by Ernst & Ernst was completed in December 1967 and the first complaint in this action was not filed until February 1971.

The Court of Appeals for the Seventh Circuit reversed and remanded, holding that one who breaches a duty of inquiry and disclosure owed another is liable in damages for aiding and abetting a third party's violation of Rule 10b-5 if the fraud would have been discovered or prevented but for the breach. 503 F. 2d 1100 (1974).<sup>2</sup> The court reasoned that Ernst & Ernst had a common-law and statutory duty of inquiry into the adequacy of First Securities' internal control system because it had contracted to audit First Securities and to prepare for filing with the Commission the annual report of its financial condition required under § 17 of the 1934 Act and Rule 17a-5. 17 CFR § 240.17a-5.<sup>3</sup> The Court further rea-

<sup>2</sup> In support of this holding, the Court of Appeals cited its decision in *Hochfelder v. Midwest Stock Exchange, supra*, where it detailed the elements necessary to establish a claim under Rule 10b-5 based on a defendant's aiding and abetting a securities fraud solely by inaction. See n. 3 *supra*. In such a case the plaintiff must show "that the party charged with aiding and abetting had knowledge of or, but for the breach of a duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." *Id.*, at 374. The court explained in the instant case that these "elements constitute a flexible standard of liability which should be amplified according to the peculiarities of each case." 503 F. 2d, at 1104. In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10 (b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the rule, nor the elements necessary to establish such a cause of action. See, e. g., *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (1966), 285 F. Supp. 702 (ND Ind. 1968), *aff'd*, 417 F. 2d 147 (CA7 1969), *cert. denied*, 397 U. S. 980 (1970) (defendant held liable for giving active and knowing assistance to a third party engaged in violations of the securities laws). See generally Huber, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597, 620-645 (1972).

<sup>3</sup> See n. 1, *supra*.



## F ERNST &amp; ERNST v. HOCHFELDER

sioned that respondents were beneficiaries of the statutory duty to inquire" and the related duty to disclose any material irregularities that were discovered. *Id.*, at 1103-1111. The court concluded that there were genuine issues of fact as to whether Ernst & Ernst's failure to discover and comment upon Nay's mail rule<sup>10</sup> constituted a breach of its duties of inquiry and disclosure, *id.*, at 1111, and whether inquiry and disclosure would have led to the discovery or prevention of Nay's fraud. *Id.*, at 1115.<sup>11</sup>

<sup>10</sup> The court concluded that the duty of inquiry imposed on Ernst & Ernst under § 17 (a) was "grounded on a concern for the protection of investors such as [respondents]," without reaching the question whether the statute imposed a "direct duty" to the respondents. 503 F. 2d, at 1103. The court held that Ernst & Ernst owed no common-law duty of inquiry to respondents arising from its contract with First Securities since Ernst & Ernst did not specifically foresee that respondents' limited class might suffer from a negligent audit, compare *Glanzer v. Shepard*, 233 N. Y. 236, 135 N. E. 275 (1922), with *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931); see, e. g., *R. I. Hospital Trust Nat'l Bank v. Sears*, 455 F. 2d 847, 851 (CA1 1972). Moreover, respondents conceded that they did not rely on the financial statements and reports prepared by Ernst & Ernst or on its certificate of opinion. 503 F. 2d, at 1107.

<sup>11</sup> In their briefs respondents allude to several other alleged failings by Ernst & Ernst in its audit of First Securities, principally its failure to inquire into the collectibility of certain loans by First Securities to Nay and its failure to follow up on a 1965 memorandum that characterized First Securities' overall system of internal control as weak because of the centralization of functions in the cashier. The Court of Appeals mentioned none of these alleged deficiencies in its opinion in the case, although it did discuss the loans to Nay and certain other related matters in its opinion in *Hochfelder v. Midwestern Stock Exchange*, 503 F. 2d, at 373-374, holding that the existence of these facts was insufficient to put the Exchange on notice that further inquiry into First Securities' financial affairs was required.

<sup>12</sup> The Court of Appeals also reversed the District Court's holding

We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10 (b) and Rule 10b-5 in the absence of any allegation of scienter—an intent to deceive, manipulate, or defraud.<sup>12</sup> 421 U. S. 909 (1975). We conclude that it will not and therefore we reverse.<sup>13</sup>

with respect to equitable estoppel and the statute of limitations. See n. 8, *supra*. In view of our disposition of the case we need not address these issues.

<sup>12</sup> Although the verbal formulations of the standard to be applied have varied, several courts of appeals have held in substance that negligence alone is sufficient for civil liability under § 10 (b) and Rule 10b-5. See, e. g., *White v. Abrams*, 455 F. 2d 724, 730 (CA9 1974) ("flexible duty" standard); *Mazel v. Fields*, 386 F. 2d 718, 735 (CA8 1967), cert. denied, 390 U. S. 951 (1968) (negligence sufficient); *Kohler v. Kohler Co.*, 319 F. 2d 634 (CA7 1963) (knowledge not required). Other courts of appeals have held that some type of scienter—i. e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud—is necessary in such an action. See, e. g., *Clegg v. Cook*, 507 F. 2d 1351, 1361-1362 (CA10 1974), cert. denied, 422 U. S. 1007 (1975) (an element of "scienter or conscious fault"); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1306 (CA2 1973) ("willful or reckless disregard" of the truth). But few of the decisions announcing that some form of negligence suffices for civil liability under § 10 (b) and Rule 10b-5 actually have involved only negligent conduct. *Smuldown v. Pearl Brewing Co.*, 480 F. 2d 570, 606 (CA5), cert. denied, 419 U. S. 879 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 266 (CA3 1972) (Adams, J., concurring); *Bookin, Seemster and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 568-570 (1952).

In this opinion the term "scienter" refers to a mental state embracing an intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10 (b) and Rule 10b-5.

<sup>13</sup> Respondents further contend that Ernst & Ernst owed them a direct duty under § 17 (a) and Rule 17a-5 of the 1934 Act to conduct a proper audit of First Securities and that they may premise a



## II

Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929. The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended 15 U. S. C. § 77a *et seq.*, was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H. R. Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges. See S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934). Although the Acts contain numerous carefully drawn express civil remedies and criminal penalties, Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the 1934 Act Congress created the Commission, which is provided with an arsenal of flexible enforcement powers. See, e. g., 1933 Act §§ 8, 19, 20, 48 Stat. 79, 85, 86, as amended, 15 U. S. C. §§ 77h, 77s, 77t; 1934 Act §§ 9, 19, 21, 48 Stat. 880, 898, 899, as amended, 15 U. S. C. §§ 78i, 78s, 78u.

private cause of action against Ernst & Ernst for violation of that duty. Respondents' cause of action, however, was premised solely on the alleged violation of § 10(b) and Rule 10b-5. During the lengthy history of the litigation they have not amended their original complaint to aver a cause of action under § 17(a) and Rule 17a-5. We therefore do not consider that a claim of liability under § 17(a) is properly before us even assuming respondents could assert such a claim independently of § 10(b).

Section 10 of the 1934 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." 15 U. S. C. § 78j. In 1942, acting pursuant to the power conferred by § 10 (b), the Commission promulgated Rule 10b-5, which now provides:

"Employment of manipulative and deceptive devices.

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

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

"(2) 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

"(3) 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."

Although § 10 (b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress,<sup>14</sup> or the Commission when

<sup>14</sup> See, e. g., S. Rep. No. 792, 73d Cong., 2d Sess., 5-6 (1934); Note, Implied Liability Under the Securities Exchange Act, 61 *Harv. L. Rev.* 858, 860 (1948).



adopting Rule 10b-5,<sup>15</sup> contemplated such a remedy, the existence of a private cause of action for violations of the statute and the rule is now well established. *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U. S. 128, 150-154 (1972); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U. S. 6, 13 n. 9 (1971). During the 30-year period since a private cause of action was first implied under § 10(b) and Rule 10b-5,<sup>16</sup> a substantial body of case law and commentary has developed as to its elements. Courts and commentators long have differed with regard to whether scienter is a necessary element of such a cause of action, or whether negligent conduct alone is sufficient.<sup>17</sup> In addressing this question, we turn first to the language of § 10(b), for "[t]he starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps*, *supra*, at 756 (Powell, J., concurring); *e. g.*, *FTC v. Bunte Brothers, Inc.*, 312 U. S. 349, 350 (1941).

## A

Section 10(b) makes unlawful the use or employment of "any manipulative or deceptive device or con-

<sup>15</sup> SEC Securities Exchange Release No. 3230 (1942); *Birnbaum v. Newport Steel Corp.*, 193 F. 2d 461, 463 (CA2), *cert. denied*, 343 U. S. 956 (1952).

<sup>16</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>17</sup> See cases cited in n. 12, *supra*. Compare, *e. g.*, Comment, *Scienter and Rule 10b-5*, 60 Cal. L. Rev. 1057, 1080-1081 (1969); Note, *Negligent Misrepresentations under Rule 10b-5*, 32 Chi. L. Rev. 824, 830-844 (1965); Note, 82 Harv. L. Rev. 938, 947 (1969); Note, *Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 Yale L. J. 658, 682-689 (1965), with, *e. g.*, 3 L. Loss, *Securities Regulation* 1706 (2d ed. 1961); 6 *id.*, at 3883-3885 (Supp. 1969).

trivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10 (b) was intended to proscribe knowing or intentional misconduct. See *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 868 (CA2 1968) (Friendly, J., concurring), cert. denied *sub nom. Kline v. SEC*, 394 U. S. 976 (1969); Loss, Summary Remarks, 30 Bus. Lawyer 163, 165 (1975). See also *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 280 (CA3 1972) (Adams, J., concurring).

In its *amicus curiae* brief, however, the Commission contends that nothing in the language "manipulative or deceptive device or contrivance" limits its operation to knowing or intentional practices.<sup>18</sup> In support of its view, the Commission cites the overall congressional purpose in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them. See *Affiliated Ute Citizens v. United States*, 406 U. S., at

<sup>18</sup> The Commission would not permit recovery upon proof of negligence in all cases. In order to harmonize civil liability under § 10 (b) with the express civil remedies contained in the 1933 and 1934 Acts, the Commission would limit the circumstances in which civil liability could be imposed for negligent violation of Rule 10b-5 to situations in which (i) the defendant knew or reasonably could foresee that the plaintiff would rely on his conduct, (ii) the plaintiff did in fact so rely, and (iii) the amount of the plaintiff's damages caused by the defendant's conduct was definite and ascertainable. Brief of *Amicus Curiae* 23-33. The Commission concludes that the present record does not establish these conditions since it could not reasonably have been foreseen that the financial statements of First Securities would induce respondents to invest in the escrow accounts, respondents in fact did not rely on Ernst & Ernst's audits, and the amount of respondents' damages was unascertainable. *Id.*, 33-36. Respondents accept the Commission's basic analysis of the operative language of the statute and rule, but reject these additional requirements for recovery for negligent violations.



151; *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U. S., at 11-12; *J. I. Case Co. v. Borak*, 377 U. S. 426, 432-433 (1964). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1963). The Commission then reasons that since the "effect" upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning. See, e. g., *Addison v. Holly Hill Fruit Products, Inc.*, 322 U. S. 607, 617-618 (1944).<sup>19</sup> The argument simply ignores the use of the words "manipulative" "device" or "contrivance," terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.<sup>20</sup> Use of the

<sup>19</sup> "To let general words draw on some purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another . . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him." 322 U. S., at 617-618. See Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Col. L. Rev. 527, 536-537 (1947).

<sup>20</sup> Webster's Int'l Dictionary (2d ed. 1934) defines "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice," and "contrivance" in pertinent part as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "[t]o devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . . ." The Commission also ignores the use of the terms "[t]o use or

word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.<sup>21</sup>

In addition to relying upon the Commission's argument with respect to the operative language of the statute, respondents contend that since we are dealing with "remedial legislation," *Tcherepnin v. Knight*, 389 U. S. 332, 336 (1967), it must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens v. United States*, 406 U. S., at 151, quoting *SEC v. Capital Gains Research Bureau*, *supra*, at 186. They argue that the "remedial purposes" of the Acts demand a construction of § 10 (b) that embraces negligence as a standard of liability. But in seeking to accomplish its broad remedial goals, Congress did not adopt uniformly a negligence standard even as to express civil remedies. In some circumstances and with respect to certain classes of defendants, Congress did create express liability predicated upon a failure to exercise reasonable care. *E. g.*, 1933 Act § 11 (b) (3) (B), 48 Stat. 82 as amended 15 U. S. C. § 77k (b) (3) (B) (liability of "experts," such as accountants, for misleading statements in portions of registration statements for which they are responsible).<sup>22</sup> But in other situations good faith is an absolute defense. 1934 Act § 18, 48 Stat. 897, as amended 15 U. S. C. § 78r (misleading statements

employ," language that is supportive of the view that Congress did not intend § 10 (b) to embrace negligent conduct.

<sup>21</sup> Webster's Int'l Dictionary, *supra*, defines "manipulate" as ". . . to manage or treat artfully or fraudulently; as to manipulate accounts . . . 4. *Exchanges*. To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig."

<sup>22</sup> See p. 21 & n. 26, *infra*.



in any document filed pursuant to the 1934 Act). And in still other circumstances Congress created express liability regardless of the defendant's fault, 1933 Act § 11 (a) (issuer liability for misleading statements in the registration statement).

It is thus evident that Congress fashioned standards of fault in the express civil remedies in the 1933 and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section. Where, as here, we deal with a judicially implied liability, the statutory language certainly is no less important. In view of the language of § 10 (b) which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its context, *United States v. Oregon*, 366 U. S. 643, 648 (1961); *Packard Motor Car Co. v. NLRB*, 330 U. S. 485, 492 (1947), further inquiry may be unnecessary. We turn now, nevertheless, to the legislative history of the 1934 Act to ascertain whether there is support for the meaning attributed to § 10 (b) by the Commission and respondents.

#### B

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, we think the relevant portions of that history support our conclusion that § 10 (b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.

The original version of what would develop into the 1934 Act was contained in identical bills introduced by Senator Fletcher and Representative Rayburn. S. 2693,

73d Cong., 2d Sess. (1934); H. R. 7852, 73d Cong., 2d Sess. (1934). Section 9 (c) of the bills, from which present § 10 (b) evolved, proscribed as unlawful the use of "any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors." The other subsections of proposed § 9 listed specific practices that Congress empowered the Commission to regulate through its rulemaking power. See §§ 9 (a) (short sale), (b) ("stop-loss order"). Soon after the hearings on the House bill were held, a substitute bill was introduced in both Houses which abbreviated and modified § 9 (c)'s operative language to read "any manipulative device or contrivance." S. 3420, 73d Cong., 2d Sess., § 10 (b) (1934); H. R. 8720, 73d Cong., 2d Sess., 9 (c) (1934). Still a third bill, retaining the Commission's power to regulate the specific practices enumerated in the prior bills, and omitting all reference to the Commission's authority to prescribe rules concerning manipulative or deceptive devices in general, was introduced and passed in the House. H. R. 9323, 73d Cong., 2d Sess., § 9 (1934). The final language of § 10 is a modified version of a Senate amendment to this last House bill. See H. R. Rep. No. 1838, 73d Cong., 2d Sess., 32-33 (1934) (Conference Report).

Neither the intended scope of § 10 (b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation. There is no indication, however, that § 10 (b) was intended to proscribe conduct not involving scienter. The extensive hearings that preceded passage of the 1934 Act touched only briefly on § 10, and most of the discussion was devoted to the enumerated devices that the



Commission is empowered to proscribe under § 10 (a). The most relevant exposition of the provision that was to become § 10 (b) was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:

"Subsection (c) [§ 9 (c) of H. R. 7852—later § 10 (b)] says, 'Thou shalt not devise any other cunning devices.' . . .

"Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."

Hearings on H. R. 7852 and H. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934). This brief explanation of § 10 (b) by a spokesman for its drafters is significant. The section was described rightly as a "catch-all" clause to enable the Commission "to deal with new manipulative [or cunning] devices." It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions.<sup>23</sup> Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing "manipulative [or cunning] devices"<sup>24</sup> to include negligence.

<sup>23</sup> See n. 21, *supra*.

<sup>24</sup> In support of its position the Commission cites statements by Corcoran in the Senate hearings that "in modern society there are many things you have to make crimes which are sheer matters of negligence" and "intent is not necessary for every crime." Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., 6509-6510 (1934). The comment, taken in context, sheds no light on the meaning of § 10 (b). Corcoran's remarks were made during a discussion of whether criminal violations could arise under § 8 (a) (3) of S. 2693, 73d Cong., 2d

The legislative reports do not address the scope of § 10 (b) or its catch-all function directly. In considering specific manipulative practices left to Commission regulation, however, the reports indicate that liability would not attach absent scienter, supporting the conclusion that Congress intended no lesser standard under § 10 (b). The Senate Report of S. 3420 discusses gener-

---

Sess., which in material part was incorporated in § 9 of the 1934 Act, 15 U. S. C. § 78; in the absence of specific intent to influence security prices for personal gain. The remarks, moreover, were not addressed to the scope of § 8, but were general observations concerning activity society might proscribe under criminal law. Ferdinand Pecora, counsel to the committee and a draftman of S. 2693, *Foremost-McKesson, Inc. v. Provident Securities Co.*, — U. S. —, — n. 24 (1976), described the language as "[e]xcluding from its scope an act that is not done with any ulterior motives or purposes, as set forth in the act." *Id.*, at 6510. Further, prior to the passage of the 1934 Act, proposed § 8 was amended to require willful behavior as a prerequisite to civil liability for violations. Compare § 9 (e) of the 1934 Act with § 8 (e) of S. 2693. See H. R. Rep. No. 1383, 73d Cong., 2d Sess., 21 (1934).

The Commission also relies on objections to a draft version of § 10 (b)—§ 9 (c) of S. 2693 and H. R. 7852, see pp. 14-15, *supra*—raised by representatives of the securities industry in the House and Senate hearings. They warned that the language was so vague that the Commission might outlaw anything. *E. g.*, Hearings on Stock Exchange Practices, *supra*, at 6988; Hearings on H. R. 7852 and H. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 258 (1934). Remarks of this kind made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill, are entitled to little weight. See, *e. g.*, *United States v. United Mine Workers*, 330 U. S. 258, 276-277 (1947); *United States v. Wrightwood Dairy Co.*, 315 U. S. 110, 125 (1942). This is especially so with regard to the statements of legislative opponents who "[i]n their zeal to defeat a bill . . . understandably tend to overstate its reach." *NLRB v. Fruit Packers*, 377 U. S. 58, 66 (1964). See *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U. S. 384, 394-395 (1951).



ally the various abuses that precipitated the need for the legislation and the inadequacy of self-regulation by the stock exchanges. The Report then analyzes the component provisions of the statute, but does not parse § 10. The only specific reference to § 10 is the following:

"In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10 and 16." S. Rep. 792, 73d Cong., 2d Sess., 6 (1934).

In the portion of the general analysis section of the Report entitled "Manipulative Practices," however, there is a discussion of specific practices that were considered so inimical to the public interest as to require express prohibition, such as "wash" sales and "matched" orders,<sup>25</sup> and of other practices that might in some cases serve legitimate purposes, such as stabilization of security prices and grants of options. *Id.*, at 7-9. These latter practices were left to regulation by the Commission. 1934 Act §§ 9 (a)(6), (c), 48 Stat. 890, 15 U. S. C. §§ 78i (a)(6), (c). Significantly, we think, in the discussion of

<sup>25</sup> "Wash" sales are transactions involving no change in beneficial ownership. "Matched" orders are orders for the purchase/sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security. Section 9 (a)(1) of the 1934 Act, 15 U. S. C. § 78i (a)(1), proscribes wash sales and matched orders when effectuated "[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or . . . with respect to the market for any such security." See *In re J. A. Latimer & Co.*, 38 S. E. C. 790 (1958); *In re Thornton & Co.*, 28 S. E. 208 (1948).

this latter category of specified manipulative practices, there is no indication that any type of criminal or civil liability is to attach in the absence of scienter. For example, in discussing the potential abuses resulting from the use of options, the Report indicates that self-regulation by securities exchanges had proved inadequate because members might deliberately circumvent the rules of the exchange by employing nonmembers to execute transactions. *Id.*, at 9. Furthermore, in commenting on the express civil liabilities provided in the 1934 Act, the Report explains:

" . . . if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party. . . . The bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in *good faith*." *Id.*, at 12-13 (emphasis supplied).

With regard to the specified manipulative practices considered in the Report, therefore, there is revealed an overall congressional intent to prevent "manipulative and deceptive practices . . . which fulfill no useful function" and to create private actions for damages stemming from "illicit practices," where the defendant has not acted in good faith. The views expressed in the House Report are consistent with this interpretation. H. Rep. No.



1383, 73d Cong., 2d Sess., 10-11, 20-21 (1934) (H. R. 9323). There is no indication that Congress intended anyone to be made liable for misleading conduct or misstatement unless he acted other than in good faith. The catch-all provision of § 10 (b) should be interpreted no more broadly.

## C

The 1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities. See *Blue Chip Stamps*, 421 U.S., at 727-730. As the Court indicated in *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen. . . ." Recognizing this, respondents and the Commission contrast § 10 (b) to other sections of the Acts to support their contention that civil liability may be imposed upon proof of negligent conduct. We think they misconceive the significance of the other provisions of the Acts.

The Commission argues that Congress has been explicit in requiring willful conduct when that was the standard of fault intended, citing § 9 of the 1934 Act, 48 Stat. 889, 15 U.S.C. § 78i, which generally proscribes manipulation of securities prices. Sections 9 (a)(1) and (a)(2), for example, respectively prohibit manipulation of security prices "[f]or the purpose of creating a false or misleading appearance of actual trading in any security . . . or . . . with respect to the market for any such security," and "for the purpose of including the purchase or sale of such security by others." See also § 9 (a)(4). Section 9 (e) then imposes upon "[a]ny person who willfully participates in any act or transaction in violation of" other provisions of § 9 civil liability to anyone who purchased or sold a security at a price affected by the manipulative





*Barchris Construction Corp.*, 283 F. Supp. 643, 697-703 (SDNY 1968). The express recognition of a cause of action premised on negligent behavior in § 11 stands in sharp contrast to the language of § 10 (b), and significantly undercuts the Commission's argument.

We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct, see §§ 11, 12 (2), 15, 15 U.S.C. §§ 77k, 77l, 77o,<sup>27</sup> are subject to significant procedural restrictions not applicable under § 10 (b).<sup>28</sup> Section 11 (e) of the 1933

registration statement was not misleading. §§ 11 (b)(3)(A), (C), (D), (e). See, e.g., *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 575-583 (EDNY 1971) (underwriters, but not officer-directors, established their due diligence defense). See generally R. Jennings & H. Marsh, *Securities Regulation* 1018-1027 (3d ed. 1972), and sources cited therein; Falk, *Civil Liabilities under the Federal Securities Acts: The Barchris Case*, 55 Va. L. Rev. 199 (1969).

<sup>27</sup> Section 12 (2) creates potential civil liability for a seller of securities in favor of the purchaser for misleading statements or omissions in connection with the transaction. The seller is exculpated if he proves that he did not know, or in the exercise of reasonable care, could not have known of the untruth or omission. Section 15 of the 1933 Act, as amended by § 208 of Title II of the 1934 Act, makes persons who "control" any person liable under § 11 or § 12 liable jointly and severally to the same extent as the controlled person, unless he "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 15 U.S.C. § 77o. See Act of June 6, 1934, Pub. L. No. 291, c. 404, Title II § 208, 48 Stat. 908.

<sup>28</sup> Each of the provisions of the 1934 Act that expressly create civil liability, except those directed to specific classes of individuals such as directors, officers, or 10% beneficial holders of securities, see § 16 (b), 15 U.S.C. § 78p, *Foremost-McKesson, Inc. v. Provident Securities Co.*, *supra*; *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973), contains a state-of-mind something more than negligence. Section 9 creates potential civil liability for any person who "willfully participates" in the manipulation of securities on a national exchange. § 9 (e), 15 U.S.C. § 78i (e).

Act, for example, authorizes the court to require a plaintiff bringing a suit under § 11, § 12 (2), or § 15 thereof to post a bond for costs, including attorneys' fees. Section 13 specifies a statute of limitations of one year from the time the violation was or should have been discovered, in no event to exceed three years from the time of offer or sale, applicable to actions brought under § 11, § 12 (2), or § 15. These restrictions, significantly, were imposed by amendments to the 1933 Act passed as part of the 1934 Act. Prior to amendment § 11 (e) contained no provision for payment of costs. 48 Stat. 83. Act of May 27, 1933, Pub. L. No. 22, c. 38, Title I, § 11 (e). See Act of June 6, 1934, Pub. L. No. 291, c. 404, Title II § 206 (e), 48 Stat. 908. The amendments substantially shortened the statute of limitations provided by § 13. Compare Pub. L. No. 22, *supra*, § 13, 48 Stat. 84, with 15 U. S. C. § 77m. See 1934 Act, § 207, 48 Stat. 908. See n. 28 attached that the judicially created private damage remedy under § 10 (b)—which has no comparable restrictions<sup>28</sup>—cannot be extended, consistently with

Section 18 creates potential civil liability for misleading statements filed with the Commission, but provides the defendant with the defense that "he acted in good faith and had no knowledge that such statement was false or misleading." 15 U. S. C. § 78r. And § 20 which imposes liability upon "controlling persons" for violations of the Act by those they control, exculpates a defendant who "acted in good faith and did not . . . induce the act . . . constituting the violation. . . ." 15 U. S. C. § 78t. Emphasizing the important difference between the operative language and purpose of § 14 (a) of the 1934 Act, 15 U. S. C. § 14n (a), as contrasted with § 10 (b) however, some courts have concluded that proof of scienter is unnecessary in an action for damages by the shareholder recipients of a materially misleading proxy statement against the issuer corporation. See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Kohn v. American Metal Climax, Inc.*, *supra*, at 289-290.

<sup>28</sup> Since no statute of limitations is provided for civil actions under § 10 (b), the law of limitations of the forum state is followed



the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by § 11, § 12 (2), and § 15 to be brought instead under § 10 (b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on those express actions. See, e. g., *Fischman v. Raytheon Manufacturing Co.*, 188 F. 2d 783, 786-787 (CA2 1951); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 867-868 (Friendly, J., concurring); *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123, 124 (ED Pa. 1948); 3 L. Loss, *supra*, at 1787-1788; R. Jennings & H. Marsh, *Securities Regulation 1070-1074* (3d ed. 1972). We would be unwilling to bring about this result absent substantial support in the legislative history, and there is none.<sup>30</sup>

## D

We have addressed, to this point, primarily the language and history of § 10 (b). The Commission con-

as in other cases of judicially implied remedies. See *Holmberg v. Armbrecht*, 327 U. S. 392, 395 (1946), and cases cited therein. Although it is not always certain which state statute of limitations should be followed, such statutes of limitations usually are longer than the period provided under § 13. 3 L. Loss, *supra*, at 1773-1774. As to costs see n. 30 *infra*.

<sup>30</sup> Congress regarded these restrictions on private damage actions as significant. In introducing Title II of the 1934 Act, Senator Fletcher indicated that the amendment to § 11 (e) of the 1933 Act, providing for potential payment of costs, including attorneys' fees, "is the most important [amendment] of all." 78 Cong. Rec. 8669. One of its purposes was to deter actions brought solely for their potential settlement value. See H. Rep. 1838, 73d Cong., 2d Sess., 42 (1934) (Conference Report); *Blue Chip Stamps*, *supra*, at 740-741. This deterrent is lacking in the § 10 (b) context, in which a district court's power to award attorneys' fees is sharply circumscribed. See *Alaska Pipeline Service Co. v. Wilderness Society*, 421 U. S. 240 (1975) ("bad faith" requirement); *F. D. Rich Co. v. Industrial Lumber Co.*, 417 U. S. 116, 129 (1974).

tends, however, that subsections (2) and (3) of Rule 10b-5 are cast in language which—if standing alone—could encompass both intentional and negligent behavior. These subsections respectively provide that it is unlawful “[t]o 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 light of the circumstances under which they were made, not misleading . . .” and “to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . .” Viewed in isolation the language of subsection (2), and arguably that of subsection (3), could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not.

We note first that such a reading cannot be harmonized with the administrative history of the rule, a history making clear that when the Commission adopted the rule it was intended to apply only to activities that involved scienter.<sup>21</sup> More importantly, Rule 10b-5 was

---

<sup>21</sup> Apparently the rule was a hastily drafted response to a situation clearly involving of intentional misconduct. The Commission's Regional Administrator in Boston had reported to the Director of the Trading and Exchange Division that the president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at the resultant depressed prices, when in fact the business was doing exceptionally well. The Rule was drafted and approved on the day this report was received. See Conference on Codification of the Federal Securities Laws, 23 Bus. Law. 793, 922 (1967) (remarks of Milton Freeman, one of rule's co-drafters); *Blue Chip Stamps*, *supra*, at 767 (BLACKMUN, J., dissenting). Although adopted pursuant to § 10 (b), the language of the rule appears to have been derived in significant part from § 17 of the 1933 Act, 15 U. S. C. § 77q. *E. g.*, *ibid.*; *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 887 (Friendly, J., concurring). There is no indication in the adminis-



adopted pursuant to authority granted the Commission under § 10 (b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Dixon v. United States*, 381 U. S. 68, 74 (1965), quoting *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129, 134 (1936). Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10 (b). For the reasons stated above, we think the Commission's original interpretation of Rule 10b-5 was compelled by the language and history of § 10 (b) and related sections of the Acts. See, e. g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1304-1305 (CA2 1973); *SEC v. Texas Gulf*

trative history of the Rule that any of the subsections was intended to proscribe conduct not involving scienter. Indeed the Commission's release issued contemporaneously with the rule explained:

"The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3230 (May 21, 1942).

That same year, in its Annual Report, the Commission again stated that the purpose of the rule was to protect investors against "fraud":

"During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities, while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers." 8 SEC Ann. Rep. 10 (1942).

*Sulphur Co.*, *supra*, at 868; 3 L. Loss, Securities Regulation 1766 (2d ed. 1961) (concurring opinion); 6 *id.*, at 3883-3885 (Supp. 1969). When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.<sup>22</sup>

<sup>22</sup> As we find the language and history of § 10 (b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy," set forth by the parties, that may have influenced the lawmakers in their formulation of the statute. We do note that the standard urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts. Last Term, in *Blue Chip Stamps*, *supra*, at 747-748, the Court pertinently observed:

"While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931), Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate cause':

"The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.' *Id.*, at 179-180, 174 N. E., at 444."

This case, on its facts, illustrates the extreme reach of the standard urged by respondents. As investors in transactions initiated by Nay, not First Securities, they were not foreseeable users of the financial statements prepared by Ernst & Ernst. Respondents conceded that they did not rely on either these financial statements or Ernst & Ernst's certificates of opinion. See n. 9, *supra*. The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands in other cases. Acceptance of respondents' view would extend to new frontiers the



## III

Recognizing that § 10 (b) and Rule 10b-5 might be held to require proof of more than negligent misfeasance by Ernst & Ernst as a precondition to the imposition of civil liability respondents further contend that the case should be remanded for trial under whatever standard is adopted. Throughout the lengthy history of this case respondents have proceeded on a theory of liability premised on negligence, specifically disclaiming that Ernst & Ernst had engaged in fraud or intentional misconduct.<sup>33</sup> In these circumstances, we think it inappropriate to remand the action for further proceedings.

The judgment of the Court of Appeals is

*Reversed.*

MR. JUSTICE STEVENS took no part in the consideration or decision of this case.

---

"hazards" of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress.

<sup>33</sup> See 503 F. 2d, at 1104, 1119; n. 5, *supra*.

MAR 9 1976

FILE COPY

PLEASE RETURN  
TO FILE

1st DRAFT

SUPREME COURT OF THE UNITED STATES

No. 74-1042

Ernst & Ernst, Petitioner,	} On Writ of Certiorari to the	
v.		United States Court of Ap-
Olga Hochfelder et al.		peals for the Seventh Cir- cuit.

[March —, 1976]

MR. JUSTICE POWELL delivered the opinion of the Court.

The issue in this case is whether an action for civil damages may lie under § 10 (b) of the Securities Exchange Act of 1934 (1934 Act), 48 Stat. 891, 15 U. S. C. § 78j (b), and Securities and Exchange Commission Rule 10b-5, 17 CFR § 240.10b-5, in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant.

I

Petitioner, Ernst & Ernst, is an accounting firm. From 1946 through 1967 it was retained by First Securities Company of Chicago (First Securities), a small brokerage firm and member of the Midwest Stock Exchange and of the National Association of Securities Dealers, to perform periodic audits of the firm's books and records. In connection with these audits Ernst & Ernst prepared for filing with the Securities and Exchange Commission (the Commission) the annual reports required of First Securities under § 17 (a) of the 1934 Act, 15 U. S. C. § 78g (a).<sup>3</sup> It also prepared for First Securities responses

<sup>3</sup>Section 17 (a) requires that securities brokers or dealers "make . . . and preserve . . . such accounts . . . books, and other



to the financial questionnaires of the Midwest Stock Exchange (the Exchange).

Respondents were customers of First Securities who invested in a fraudulent securities scheme perpetrated by Leston B. Nay, president of the firm and owner of 92% of its stock. Nay induced the respondents to invest funds in "escrow" accounts that he represented would yield a high rate of return. Respondents did so from 1942 through 1966, with the majority of the transactions occurring in the 1950's. In fact, there were no escrow accounts as Nay converted respondents' funds to his own use immediately upon receipt. These transactions were not in the customary form of dealings between First Securities and its customers. The respondents drew their personal checks payable to Nay or a designated bank for his account. No such escrow accounts were reflected on the books and records of First Securities, and none was shown on its periodic accounting to respondents in connection with their other investments. Nor were they included in First Securities' filings with the Commission or the Exchange.

---

records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." During the period relevant here, Commission Rule 17a-5, 17 CFR § 240.17a-5, required that First Securities file an annual report of its financial condition that included a certificate stating "clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." See SEC Release No. 3338 (Nov. 28, 1948), X-17A-5 (h). The rule required Ernst & Ernst to state in its certificate, *inter alia*, "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances" and provided that nothing in the rule should "be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit for the purpose of expressing the opinions required" by the rule.

This fraud came to light in 1968 when Nay committed suicide, leaving a note that described First Securities as bankrupt and the escrow accounts as "spurious." Respondents subsequently filed this action<sup>2</sup> for damages against Ernst & Ernst<sup>3</sup> in the United States District Court for the Northern District of Illinois under § 10 (b) of the 1934 Act. The complaint charged that Nay's escrow scheme violated § 10 (b) and Commission Rule 10b-5,<sup>4</sup> and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct proper audits of First Securities. As revealed through discovery, respondents' cause of action rested on a theory of negligent misfeasance. The premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm said to prevent an effective audit. The practice principally relied on was Nay's rule that only he could open

<sup>2</sup> Two separate, but substantially identical, complaints initially were filed by different members of the present group of respondents. Subsequently the respondents jointly filed a First Amended Complaint. The two cases were treated by the District Court as if they were consolidated and were consolidated formally on appeal.

<sup>3</sup> The first count of the complaint was directed against the Exchange, charging that through its acts and omissions it had aided and abetted Nay's fraud. Summary judgment in favor of the Exchange was affirmed on appeal, *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d 364 (CA7), cert. denied, 419 U. S. 875 (1974).

<sup>4</sup> Immediately after Nay's suicide the Commission commenced receivership proceedings against First Securities. In those proceedings all of the respondents except two asserted claims based on the fraudulent escrow accounts. These claims ultimately were allowed in *SEC v. First Securities Co.*, 463 F. 2d 981, 986 (CA7 1972), cert. denied, 409 U. S. 850 (1973), where the court held that Nay's conduct violated § 10 (b) and Rule 10b-5, and that First Securities was liable for Nay's fraud as an aider and abettor. The question of Ernst & Ernst's liability was not considered in that case.



mail addressed to him at First Securities or addressed to First Securities to his attention, even if it arrived in his absence. Respondents contended that if Ernst & Ernst had conducted a proper audit, it would have discovered this "mail rule." The existence of the rule then would have been disclosed in reports to the Exchange and to the Commission by Ernst & Ernst as an irregular procedure that prevented an effective audit. This would have led to an investigation of Nay that would have revealed the fraudulent scheme. Respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.<sup>5</sup>

After extensive discovery the District Court granted Ernst & Ernst's motion for summary judgment and dismissed the action. The court rejected Ernst & Ernst's contention that a cause of action for aiding and abetting a securities fraud could not be maintained under § 10 (b) and Rule 10b-5 merely on allegations of negligence. It concluded, however, that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards.<sup>6</sup>

---

<sup>5</sup> In their response to interrogatories in the District Court respondents conceded that they did "not accuse Ernst & Ernst of deliberate, intentional fraud," merely with "inexcusable negligence." App. 81.

<sup>6</sup> The District Court also held respondent's action was barred by the doctrine of equitable estoppel and the applicable Illinois statute of limitations of three years. See n. 29, *infra*. As customers of First Securities respondents were sent confirmation forms as required under § 17 (a) and Rule 17a-5 requesting that they verify the accuracy of the statements and notify Ernst & Ernst as to any exceptions. Although the confirmation forms contained no reference to the escrow accounts, Ernst & Ernst was not notified of this fact. The last audit of First Securities by Ernst & Ernst was completed in December 1967 and the first complaint in this action was not filed until February 1971.

The Court of Appeals for the Seventh Circuit reversed and remanded, holding that one who breaches a duty of inquiry and disclosure owed another is liable in damages for aiding and abetting a third party's violation of Rule 10b-5 if the fraud would have been discovered or prevented but for the breach. 503 F. 2d 1100 (1974).<sup>7</sup> The court reasoned that Ernst & Ernst had a common-law and statutory duty of inquiry into the adequacy of First Securities' internal control system because it had contracted to audit First Securities and to prepare for filing with the Commission the annual report of its financial condition required under § 17 of the 1934 Act and Rule 17a-5, 17 CFR § 240.17a-5.<sup>8</sup> The Court further rea-

<sup>7</sup> In support of this holding, the Court of Appeals cited its decision in *Hochfelder v. Midwest Stock Exchange, supra*, where it detailed the elements necessary to establish a claim under Rule 10b-5 based on a defendant's aiding and abetting a securities fraud solely by inaction. See n. 3 *supra*. In such a case the plaintiff must show "that the party charged with aiding and abetting had knowledge of or, but for the breach of a duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." *Id.*, at 374. The court explained in the instant case that these "elements constitute a flexible standard of liability which should be amplified according to the peculiarities of each case." 503 F. 2d, at 1104. In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10 (b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the rule, nor the elements necessary to establish such a cause of action. See, e. g., *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 873 (1966), 286 F. Supp. 702 (ND Ind. 1968), *aff'd*, 417 F. 2d 147 (CA7 1969), cert. denied, 397 U. S. 989 (1970) (defendant held liable for giving active and knowing assistance to a third party engaged in violations of the securities laws). See generally Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597, 620-645 (1972).

<sup>8</sup> See n. 1, *supra*.



soned that respondents were beneficiaries of the statutory duty to inquire<sup>9</sup> and the related duty to disclose any material irregularities that were discovered. *Id.*, at 1105-1111. The court concluded that there were genuine issues of fact as to whether Ernst & Ernst's failure to discover and comment upon Nay's mail rule<sup>10</sup> constituted a breach of its duties of inquiry and disclosure, *id.*, at 1111, and whether inquiry and disclosure would have led to the discovery or prevention of Nay's fraud. *Id.*, at 1115.<sup>11</sup>

<sup>9</sup> The court concluded that the duty of inquiry imposed on Ernst & Ernst under § 17 (a) was "grounded on a concern for the protection of investors such as [respondents]," without reaching the question whether the statute imposed a "direct duty" to the respondents. 503 F. 2d, at 1105. The court held that Ernst & Ernst owed no common-law duty of inquiry to respondents arising from its contract with First Securities since Ernst & Ernst did not specifically foresee that respondents' limited class might suffer from a negligent audit, compare *Glanzer v. Shepard*, 233 N. Y. 238, 135 N. E. 275 (1922), with *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931); see, e. g., *R. I. Hospital Trust Nat'l Bank v. Swartz*, 435 F. 2d 847, 851 (CA4 1972). Moreover, respondents conceded that they did not rely on the financial statements and reports prepared by Ernst & Ernst or on its certificate of opinion. 503 F. 2d, at 1107.

<sup>10</sup> In their briefs respondents allude to several other alleged failings by Ernst & Ernst in its audit of First Securities, principally its failure to inquire into the collectibility of certain loans by First Securities to Nay and its failure to follow up on a 1965 memorandum that characterized First Securities' overall system of internal control as weak because of the centralization of functions in the cashier. The Court of Appeals mentioned none of these alleged deficiencies in its opinion in this case, although it did discuss the loans to Nay and certain other related matters in its opinion in *Hochfelder v. Midwest Stock Exchange*, *supra*, at 370-371, holding that the existence of these facts was insufficient to put the Exchange on notice that further inquiry into First Securities' financial affairs was required.

<sup>11</sup> The Court of Appeals also reversed the District Court's holding

We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10 (b) and Rule 10b-5 in the absence of any allegation of scienter—intent to deceive, manipulate, or defraud.<sup>12</sup> 421 U. S. 909 (1975). We conclude that it will not and therefore we reverse.<sup>13</sup>

with respect to equitable estoppel and the statute of limitations. See n. 6, *supra*. In view of our disposition of the case we need not address these issues.

<sup>12</sup> Although the verbal formulations of the standard to be applied have varied, several courts of appeals have held in substance that negligence alone is sufficient for civil liability under § 10 (b) and Rule 10b-5. See, e. g., *White v. Abrams*, 495 F. 2d 724, 730 (CA9 1974) ("flexible duty" standard); *Myzel v. Fields*, 386 F. 2d 718, 735 (CA8 1967), cert. denied, 390 U. S. 951 (1968) (negligence sufficient); *Kohler v. Kohler Co.*, 319 F. 2d 634 (CA7 1963) (knowledge not required). Other courts of appeals have held that some type of scienter—i. e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud—is necessary in such an action. See, e. g., *Clegg v. Conk*, 507 F. 2d 1351, 1361-1362 (CA10 1974), cert. denied, 422 U. S. 1007 (1975) (an element of "scienter or conscious fault"); *Lanza v. Drezel & Co.*, 479 F. 2d 1277, 1306 (CA2 1973) ("willful or reckless disregard" of the truth). But few of the decisions announcing that some form of negligence suffices for civil liability under § 10 (b) and Rule 10b-5 actually have involved only negligent conduct. *Smallwood v. Pearl Brewing Co.*, 489 F. 2d 579, 606 (CA5), cert. denied, 419 U. S. 879 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 286 (CA3 1972) (Adams, J., concurring); *Bucklo*, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 568-570 (1972).

In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10 (b) and Rule 10b-5.

<sup>13</sup> Respondents further contend that Ernst & Ernst owed them a direct duty under § 17 (a) and Rule 17a-5 of the 1934 Act to conduct a proper audit of First Securities and that they may base a



## II

Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929. The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended 15 U. S. C. § 77a *et seq.*, was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H. R. Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges. See S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934). Although the Acts contain numerous carefully drawn express civil remedies and criminal penalties, Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the 1934 Act Congress created the Commission, which is provided with an arsenal of flexible enforcement powers. See, *e. g.*, 1933 Act §§ 8, 19, 20, 48 Stat. 79, 85, 86, as amended, 15 U. S. C. §§ 77h, 77s, 77t; 1934 Act §§ 9, 19, 21, 48 Stat. 889, 898, 899, as amended, 15 U. S. C. §§ 78i, 78s, 78u.

private cause of action against Ernst & Ernst for violation of that duty. Respondents cause of action, however, was premised solely on the alleged violation of § 10 (b) and Rule 10b-5. During the lengthy history of this litigation they have not amended their original complaint to aver a cause of action under § 17 (a) and Rule 17a-5. We therefore do not consider that a claim of liability under § 17 (a) is properly before us even assuming respondents could assert such a claim independently of § 10 (b).

Section 10 of the 1934 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." 15 U. S. C. § 78j. In 1942, acting pursuant to the power conferred by § 10 (b), the Commission promulgated Rule 10b-5, which now provides:

"Employment of manipulative and deceptive devices.

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

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

"(2) 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

"(3) 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."

Although § 10 (b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress,<sup>14</sup> or the Commission when

---

<sup>14</sup> See, e. g., S. Rep. No. 792, 73d Cong., 2d Sess., 5-6 (1934); Note, Implied Liability Under the Securities Exchange Act, 61 Harv. L. Rev. 858, 860 (1948).



adopting Rule 10b-5,<sup>15</sup> contemplated such a remedy, the existence of a private cause of action for violations of the statute and the rule is now well established. *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U. S. 128, 150-154 (1972); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U. S. 6, 13 n. 9 (1971). During the 30-year period since a private cause of action was first implied under § 10 (b) and Rule 10b-5,<sup>16</sup> a substantial body of case law and commentary has developed as to its elements. Courts and commentators long have differed with regard to whether scienter is a necessary element of such a cause of action, or whether negligent conduct alone is sufficient.<sup>17</sup> In addressing this question, we turn first to the language of § 10 (b), for "[t]he starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps*, *supra*, at 756 (POWELL, J., concurring); *e. g.*, *FTC v. Bunte Brothers, Inc.*, 312 U. S. 349, 350 (1941).

## A

Section 10 (b) makes unlawful the use or employment of "any manipulative or deceptive device or con-

<sup>15</sup> SEC Securities Exchange Release No. 3230 (1942); *Birnbaum v. Newport Steel Corp.*, 193 F. 2d 461, 463 (CA2), cert. denied, 343 U. S. 956 (1952).

<sup>16</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (ED Pa. 1946).

<sup>17</sup> See cases cited in n. 12, *supra*. Compare, *e. g.*, Comment, *Scienter and Rule 10b-5*, 69 Col. L. Rev. 1067, 1080-1081 (1969); Note, *Negligent Misrepresentations under Rule 10b-5*, 32 Chi. L. Rev. 824, 839-844 (1965); Note, 82 Harv. L. Rev. 938, 947 (1969); Note, *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 Yale L. J. 658, 682-689 (1965), with, *e. g.*, 3 L. Loes, *Securities Regulation* 1766 (2d ed. 1961); 6 *id.*, at 3883-3885 (Supp. 1969).

trivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10 (b) was intended to proscribe knowing or intentional misconduct. See *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 868 (CA2 1968) (Friendly, J., concurring), cert. denied *sub nom. Kline v. SEC*, 394 U. S. 976 (1969); Loss, Summary Remarks, 30 Bus. Lawyer 163, 165 (1975). See also *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 280 (CA3 1972) (Adams, J., concurring).

In its *amicus curiae* brief, however, the Commission contends that nothing in the language "manipulative or deceptive device or contrivance" limits its operation to knowing or intentional practices.<sup>28</sup> In support of its view, the Commission cites the overall congressional purpose in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them. See *Affiliated Ute Citizens v. United States*, *supra*, at

<sup>28</sup> The Commission would not permit recovery upon proof of negligence in all cases. In order to harmonize civil liability under § 10 (b) with the express civil remedies contained in the 1933 and 1934 Acts, the Commission would limit the circumstances in which civil liability could be imposed for negligent violation of Rule 10b-5 to situations in which (i) the defendant knew or reasonably could foresee that the plaintiff would rely on his conduct, (ii) the plaintiff did in fact so rely, and (iii) the amount of the plaintiff's damages caused by the defendant's conduct was definite and ascertainable. Brief of *Amicus Curiae* 23-33. The Commission concludes that the present record does not establish these conditions since Ernst & Ernst could not reasonably have foreseen that the financial statements of First Securities would induce respondents to invest in the escrow accounts, respondents in fact did not rely on Ernst & Ernst's audits, and the amount of respondents' damages was unascertainable. *Id.*, 33-36. Respondents accept the Commission's basic analysis of the operative language of the statute and rule, but reject these additional requirements for recovery for negligent violations.



151; *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U. S., at 11-12; *J. I. Case Co. v. Borak*, 377 U. S. 426, 432-433 (1964). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 193 (1963). The Commission then reasons that since the "effect" upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning. See, e. g., *Addison v. Holly Hill Fruit Products, Inc.*, 322 U. S. 607, 617-618 (1944).<sup>19</sup> The argument simply ignores the use of the words "manipulative," "device," and "contrivance," terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.<sup>20</sup> Use of the

<sup>19</sup> "To let general words draw on some purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another . . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him." *Addison v. Holly Hill Fruit Products, Inc.*, 322 U. S. 607, 617-618 (1944). See Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Col. L. Rev. 527, 535-537 (1947).

<sup>20</sup> Webster's Int'l Dictionary (2d ed. 1934) defines "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice," and "contrivance" in pertinent part as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "[t]o devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . . ."

word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.<sup>21</sup>

In addition to relying upon the Commission's argument with respect to the operative language of the statute, respondents contend that since we are dealing with "remedial legislation," *Tcherepnin v. Knight*, 389 U. S. 332, 336 (1967), it must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens v. United States*, *supra*, at 151, quoting *SEC v. Capital Gains Research Bureau*, *supra*, at 186. They argue that the "remedial purposes" of the Acts demand a construction of § 10 (b) that embraces negligence as a standard of liability. But in seeking to accomplish its broad remedial goals, Congress did not adopt uniformly a negligence standard even as to express civil remedies. In some circumstances and with respect to certain classes of defendants, Congress did create express liability predicated upon a failure to exercise reasonable care. *E. g.*, 1933 Act § 11 (b) (3) (B), 48 Stat. 82 as amended 15 U. S. C. § 77k (b) (3) (B) (liability of "experts," such as accountants, for misleading statements in portions of registration statements for which they are responsible).<sup>22</sup> But in other situations good faith is an absolute defense. 1934 Act § 18, 48 Stat. 897, as amended 15 U. S. C. § 78r (misleading statements

The Commission also ignores the use of the terms "[t]o use or employ," language that is supportive of the view that Congress did not intend § 10 (b) to embrace negligent conduct.

<sup>21</sup> Webster's Int'l Dictionary, *supra*, defines "manipulate" as "... to manage or treat artfully or fraudulently; as to *manipulate* accounts . . . . 4. *Exchanges*. To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig."

<sup>22</sup> See p. 21 & n. 26, *infra*.



in any document filed pursuant to the 1934 Act). And in still other circumstances Congress created express liability regardless of the defendant's fault, 1933 Act § 11 (a) (issuer liability for misleading statements in the registration statement).

It is thus evident that Congress fashioned standards of fault in the express civil remedies in the 1933 and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section. Where, as here, we deal with a judicially implied liability, the statutory language certainly is no less important. In view of the language of § 10 (b) which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its context, *United States v. Oregon*, 366 U. S. 643, 648 (1961); *Packard Motor Car Co. v. NLRB*, 330 U. S. 485, 492 (1947), further inquiry may be unnecessary. We turn now, nevertheless, to the legislative history of the 1934 Act to ascertain whether there is support for the meaning attributed to § 10 (b) by the Commission and respondents.

#### B

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, we think the relevant portions of that history support our conclusion that § 10 (b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.

The original version of what would develop into the 1934 Act was contained in identical bills introduced by Senator Fletcher and Representative Rayburn. S. 2693,

73d Cong., 2d Sess. (1934); H. R. 7852, 73d Cong., 2d Sess. (1934). Section 9 (c) of the bills, from which present § 10 (b) evolved, proscribed as unlawful the use of "any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors." The other subsections of proposed § 9 listed specific practices that Congress empowered the Commission to regulate through its rulemaking power. See §§ 9 (a) (short sale), (b) ("stop-loss order"). Soon after the hearings on the House bill were held, a substitute bill was introduced in both Houses which abbreviated and modified § 9 (c)'s operative language to read "any manipulative device or contrivance." S. 3420, 73d Cong., 2d Sess., § 10 (b) (1934); H. R. 8720, 73d Cong., 2d Sess., 9 (c) (1934). Still a third bill, retaining the Commission's power to regulate the specific practices enumerated in the prior bills, and omitting all reference to the Commission's authority to prescribe rules concerning manipulative or deceptive devices in general, was introduced and passed in the House. H. R. 9323, 73d Cong., 2d Sess., § 9 (1934). The final language of § 10 is a modified version of a Senate amendment to this last House bill. See H. R. Rep. No. 1838, 73d Cong., 2d Sess., 32-33 (1934) (Conference Report).

Neither the intended scope of § 10 (b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation. There is no indication, however, that § 10 (b) was intended to proscribe conduct not involving scienter. The extensive hearings that preceded passage of the 1934 Act touched only briefly on § 10, and most of the discussion was devoted to the enumerated devices that the



Commission is empowered to proscribe under § 10 (a). The most relevant exposition of the provision that was to become § 10 (b) was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:

"Subsection (c) [§ 9 (c) of H. R. 7852—later § 10 (b)] says, 'Thou shalt not devise any other cunning devices.' . . .

"Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."

Hearings on H. R. 7852 and H. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934). This brief explanation of § 10 (b) by a spokesman for its drafters is significant. The section was described rightly as a "catch-all" clause to enable the Commission "to deal with new manipulative [or cunning] devices." It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions.<sup>23</sup> Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing "manipulative [or cunning] devices" to include negligence.<sup>24</sup>

<sup>23</sup> See n. 21, *supra*.

<sup>24</sup> In support of its position the Commission cites statements by Corcoran in the Senate hearings that "in modern society there are many things you have to make crimes which are sheer matters of negligence" and "intent is not necessary for every crime." Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., 6509-6510 (1934). The comments, taken in context, shed no light on the meaning of § 10 (b). Corcoran's remarks were made during a discussion of whether criminal violations could arise under § 8 (a) (3) of S. 2893, 73d Cong., 2d

The legislative reports do not address the scope of § 10 (b) or its catch-all function directly. In considering specific manipulative practices left to Commission regulation, however, the reports indicate that liability would not attach absent scienter, supporting the conclusion that Congress intended no lesser standard under § 10 (b). The Senate Report of S. 3420 discusses gener-

---

Sess., which in material part was incorporated in § 9 of the 1934 Act, 15 U. S. C. § 78i, in the absence of specific intent to influence security prices for personal gain. The remarks, moreover, were not addressed to the scope of § 8, but were general observations concerning activity society might proscribe under criminal law. Ferdinand Pecora, counsel to the committee and a draftman of S. 2693, *Foremost-McKesson, Inc. v. Provident Securities Co.*, — U. S. —, — n. 24 (1976), described the language as "[e]xcluding from its scope an act that is not done with any ulterior motives or purposes, as set forth in the act." *Id.*, at 6510. Further, prior to the passage of the 1934 Act, proposed § 8 was amended to require willful behavior as a prerequisite to civil liability for violations. Compare § 9 (e) of the 1934 Act with § 8 (c) of S. 2693. See H. R. Rep. No. 1383, 73d Cong., 2d Sess., 21 (1934).

The Commission also relies on objections to a draft version of § 10 (b)—§ 9 (c) of S. 2693 and H. R. 7852, see pp. 14-15, *supra*—raised by representatives of the securities industry in the House and Senate hearings. They warned that the language was so vague that the Commission might outlaw anything. *E. g.*, Hearings on Stock Exchange Practices, *supra*, at 6988; Hearings on H. R. 7852 and H. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 258 (1934). Remarks of this kind made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill, are entitled to little weight. See, *e. g.*, *United States v. United Mine Workers*, 330 U. S. 258, 276-277 (1947); *United States v. Wrightwood Dairy Co.*, 315 U. S. 110, 125 (1942). This is especially so with regard to the statements of legislative opponents who "[i]n their zeal to defeat a bill . . . understandably tend to overstate its reach." *NLRB v. Fruit Packers*, 377 U. S. 58, 66 (1964). See *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U. S. 384, 394-395 (1951).



ally the various abuses that precipitated the need for the legislation and the inadequacy of self-regulation by the stock exchanges. The Report then analyzes the component provisions of the statute, but does not parse § 10. The only specific reference to § 10 is the following:

"In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10 and 16." S. Rep. 792, 73d Cong., 2d Sess., 6 (1934).

In the portion of the general analysis section of the Report entitled "Manipulative Practices," however, there is a discussion of specific practices that were considered so inimical to the public interest as to require express prohibition, such as "wash" sales and "matched" orders,<sup>24</sup> and of other practices that might in some cases serve legitimate purposes, such as stabilization of security prices and grants of options. *Id.*, at 7-9. These latter practices were left to regulation by the Commission. 1934 Act §§ 9 (a)(6), (c), 48 Stat. 890, 15 U. S. C. §§ 78i (a)(6), (c). Significantly, we think, in the discussion of

<sup>24</sup> "Wash" sales are transactions involving no change in beneficial ownership. "Matched" orders are orders for the purchase/sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security. Section 9 (a)(1) of the 1934 Act, 15 U. S. C. § 78i (a)(1), proscribes wash sales and matched orders when effectuated "[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or . . . with respect to the market for any such security." See *In re J. A. Latimer & Co.*, 38 S. E. C. 790 (1958); *In re Thornton & Co.*, 28 S. E. C. 208 (1945).

the need to regulate even the latter category of practices when they are manipulative, there is no indication that any type of criminal or civil liability is to attach in the absence of scienter. Furthermore, in commenting on the express civil liabilities provided in the 1934 Act, the Report explains:

" . . . if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party. . . . The bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in good faith." *Id.*, at 12-13 (emphasis supplied).

The Report therefore reveals with respect to the specified practices, an overall congressional intent to prevent "manipulative and deceptive practices . . . which fulfill no useful function" and to create private actions for damages stemming from "illicit practices," where the defendant has not acted in good faith. The views expressed in the House Report are consistent with this interpretation. H. Rep. No. 1383, 73d Cong., 2d Sess., 10-11, 20-21 (1934) (H. R. 9323). There is no indication that Congress intended any one to be made liable for such practices unless he acted other than in good faith. The catch-all provision of § 10 (b) should be interpreted no more broadly.



## C

The 1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities. See *Blue Chip Stamps*, 421 U. S., at 727-730. As the Court indicated in *SEC v. National Securities, Inc.*, 393 U. S. 453 (1969), "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen. . . ." Recognizing this, respondents and the Commission contrast § 10 (b) to other sections of the Acts to support their contention that civil liability may be imposed upon proof of negligent conduct. We think they misconceive the significance of the other provisions of the Acts.

The Commission argues that Congress has been explicit in requiring willful conduct when that was the standard of fault intended, citing § 9 of the 1934 Act, 48 Stat. 889, 15 U. S. C. § 78i, which generally proscribes manipulation of securities prices. Sections 9 (a)(1) and (a)(2), for example, respectively prohibit manipulation of security prices "[f]or the purpose of creating a false or misleading appearance of actual trading in any security . . . or . . . with respect to the market for any such security," and "for the purpose of including the purchase or sale of such security by others." See also § 9 (a)(4). Section 9 (e) then imposes upon "[a]ny person who willfully participates in any act or transaction in violation of" other provisions of § 9 civil liability to anyone who purchased or sold a security at a price affected by the manipulative activities. From this the Commission concludes that since § 10 (b) is not by its terms explicitly restricted to willful, knowing, or purposeful conduct, it should not be construed in all cases to require more than negligent action or inaction as a precondition for civil liability.

The structure of the Acts does not support the Com-

mission's argument. In 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. See 1933 Act, §§ 11, 12, 15, 48 Stat. 82, 84, as amended 15 U. S. C. §§ 77k, 77l, 77o; 1934 Act §§ 9, 18, 20, 48 Stat. 889, 897, 899, as amended 15 U. S. C. §§ 78i, 78r, 78t. For example, § 11 of the 1933 Act unambiguously creates a private action for damages when a registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading. Within the limits specified by § 11 (e), the issuer of the securities is held absolutely liable for any damages resulting from such misstatement or omission. But experts such as accountants who have prepared portions of the registration statement are accorded a "due diligence" defense. In effect, this is a negligence standard. An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that "after reasonable investigation" he had "reasonable ground[s] to believe" that the statements for which he was responsible were true and there was no omission of a material fact.<sup>26</sup> § 11 (b)(3)(B)(i). See, e. g., *Escott v.*

<sup>26</sup> Other individuals who sign the registration statement, directors of the issuer, and the underwriter of the securities similarly are accorded a complete defense against civil liability based on the exercise of reasonable investigation and a reasonable belief that the registration statement was not misleading. §§ 11 (b)(3)(A), (C), (D), (e). See, e. g., *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 575-583 (EDNY 1971) (underwriters, but not officer-directors, established their due diligence defense). See generally R. Jennings & H. Marsh, *Securities Regulation* 1018-1027 (3d ed. 1972), and sources cited therein; Folk, *Civil Liabilities under the Federal Securities Acts: The Barchris Case*, 55 Va. L. Rev. 199 (1969).



*Barchris Construction Corp.*, 283 F. Supp. 643, 697-703 (SDNY 1968). The express recognition of a cause of action premised on negligent behavior in § 11 stands in sharp contrast to the language of § 10 (b), and significantly undercuts the Commission's argument.

We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct, see §§ 11, 12 (2), 15, 15 U.S.C. §§ 77k, 77l, 77o,<sup>27</sup> is subject to significant procedural restrictions not applicable under § 10 (b).<sup>28</sup> Section 11 (e) of the 1933

<sup>27</sup> Section 12 (2) creates potential civil liability for a seller of securities in favor of the purchaser for misleading statements or omissions in connection with the transaction. The seller is exculpated if he proves that he did not know, or in the exercise of reasonable care, could not have known of the untruth or omission. Section 15 of the 1933 Act, as amended by § 208 of Title II of the 1934 Act, makes persons who "control" any person liable under § 11 or § 12 liable jointly and severally to the same extent as the controlled person, unless he "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 15 U.S.C. § 77o. See Act of June 6, 1934, Pub. L. No. 291, c. 404, Title II § 208, 48 Stat. 908.

<sup>28</sup> Each of the provisions of the 1934 Act that expressly create civil liability, except those directed to specific classes of individuals such as directors, officers, or 10% beneficial holders of securities, see § 16 (b), 15 U.S.C. § 78p, *Foremost-McKesson, Inc. v. Provident Securities Co.*, *supra*; *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973), contains a state-of-mind condition requiring something more than negligence. Section 9 creates potential civil liability for any person who "willfully participates" in the manipulation of securities on a national exchange. § 9 (e). 15 U.S.C. § 78i (e). Section 18 creates potential civil liability for misleading statements filed with the Commission, but provides the defendant with the defense that "he acted in good faith and had no knowledge that such statement was false or misleading." 15 U.S.C. § 78r. And § 20, which imposes liability upon "controlling persons" for violations of the Act by those they control, exculpates a defendant who "acted in good faith and did not . . . induce the act . . .

Act, for example, authorizes the court to require a plaintiff bringing a suit under § 11, § 12 (2), or § 15 thereof to post a bond for costs, including attorneys' fees and in specified circumstances to assess costs at the conclusion of the litigation. Section 13 specifies a statute of limitations of one year from the time the violation was or should have been discovered, in no event to exceed three years from the time of offer or sale, applicable to actions brought under § 11, § 12 (2), or § 15. These restrictions, significantly, were imposed by amendments to the 1933 Act adopted as part of the 1934 Act. Prior to amendment § 11 (e) contained no provision for payment of costs. 48 Stat. 83. Act of May 27, 1933, Pub. L. No. 22, c. 38, Title I, § 11 (e). See Act of June 6, 1934, Pub. L. No. 291, c. 404, Title II § 206 (e), 48 Stat. 908. The amendments also substantially shortened the statute of limitations provided by § 13. Compare Pub. L. No. 22, *supra*, § 13, 48 Stat. 84, with 15 U. S. C. § 77m. See 1934 Act, § 207, 48 Stat. 908. We think these procedural limitations indicate that the judicially created private damage remedy under § 10 (b)—which has no comparable restrictions<sup>29</sup>—cannot be

constituting the violation. . . ." 15 U. S. C. § 78t. Emphasizing the important difference between the operative language and purpose of § 14 (a) of the 1934 Act, 15 U. S. C. § 14n (a), as contrasted with § 10 (b), however, some courts have concluded that proof of scienter is unnecessary in an action for damages by the shareholder recipients of a materially misleading proxy statement against the issuer corporation. See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Kohn v. American Metal Climax, Inc.*, *supra*, at 289-290.

<sup>29</sup> Since no statute of limitations is provided for civil actions under § 10 (b), the law of limitations of the forum state is followed as in other cases of judicially implied remedies. See *Holmberg v. Armbricht*, 327 U. S. 392, 395 (1946), and cases cited therein. Although it is not always certain which state statute of limitations should be followed, such statutes of limitations usually are longer



extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by § 11, § 12 (2), and § 15 to be brought instead under § 10 (b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.<sup>20</sup> See, e. g., *Fischman v. Raytheon Manufacturing Co.*, 188 F. 2d 783, 786-787 (CA2 1951); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 867-868 (Friendly, J., concurring); *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123, 124 (ED Pa. 1948); 3 L. Loss, *Securities Regulation* 1787-1788 (2d ed. 1961); R. Jennings & H. Marsh, *Securities Regulation* 1070-1074 (3d ed. 1972). We would be unwilling to bring about this result absent substantial support in the legislative history, and there is none.<sup>21</sup>

than the period provided under § 13. 3 L. Loss, *supra*, at 1773-1774. As to costs see n. 30 *infra*.

<sup>20</sup> Congress regarded these restrictions on private damage actions as significant. In introducing Title II of the 1934 Act, Senator Fletcher indicated that the amendment to § 11 (e) of the 1933 Act, providing for potential payment of costs, including attorneys' fees, "is the most important [amendment] of all." 78 Cong. Rec. 8669. One of its purposes was to deter actions brought solely for their potential settlement value. See *ibid.*; H. Rep. 1838, 73d Cong., 2d Sess., 42 (1934) (Conference Report); *Blue Chip Stamps, supra*, at 740-741. This deterrent is lacking in the § 10 (b) context, in which a district court's power to award attorneys' fees is sharply circumscribed. See *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U. S. 240 (1975) ("bad faith" requirement); *F. D. Rich Co. v. Industrial Lumber Co.*, 417 U. S. 116, 129 (1974).

<sup>21</sup> Section 18 of the 1934 Act creates a private cause of action against persons, such as accountants, who "make or cause to be made" materially misleading statements in reports or other documents filed with the Commission. 15 U. S. C. § 78r. We need not consider the question whether a cause of action may be maintained under § 10 (b) on the basis of actions that would constitute a violation of § 18. Under § 18 liability extends to persons who, in reliance on such statements, purchased or sold a security whose price

## D

We have addressed, to this point, primarily the language and history of § 10 (b). The Commission contends, however, that subsections (2) and (3) of Rule 10b-5 are cast in language which—if standing alone—could encompass both intentional and negligent behavior. These subsections respectively provide that it is unlawful “[t]o 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 light of the circumstances under which they were made, not misleading . . .” and “to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . .” Viewed in isolation the language of subsection (2), and arguably that of subsection (3), could be read as proscribing, respectively, any type of material misstatement or omission, and any

was affected by the statements. Liability is limited, however, in the important respect that the defendant is accorded the defense that he acted in “good faith and had no knowledge that such statement was false or misleading.” Consistent with this language the legislative history of the section suggests something more than negligence on the part of the defendant is required for recovery. The original version of § 18 (a), § 17 (a) of S. 2693, H. R. 7856 and H. R. 7855, see pp. 14-15, *supra*, provided that the defendant would not be liable if “he acted in good faith and in the exercise of reasonable care had no ground to believe that such statement was false or misleading.” The accounting profession objected to this provision on the ground that liability would be created for honest errors in judgment. See Senate Hearings on Stock Exchange Practices, *supra*, at 7175-7183; House Hearings on H. R. 7852 and H. R. 8720, *supra*, at 653. In subsequent drafts the current formulation was adopted. It is also significant that actions under § 18 are limited by a relatively short statute of limitations similar to that provided in § 13 of the 1933 Act. § 18 (e). Moreover, as under § 11 (e) of the 1933 Act the District Court is authorized to require the plaintiff to post a bond for costs, including attorney’s fees, and to assess such costs at the conclusion of the litigation. § 18 (a).



course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not.

We note first that such a reading cannot be harmonized with the administrative history of the rule, a history making clear that when the Commission adopted the rule it was intended to apply only to activities that involved scienter.<sup>32</sup> More importantly, Rule 10b-5 was

---

<sup>32</sup> Apparently the rule was a hastily drafted response to a situation clearly involving intentional misconduct. The Commission's Regional Administrator in Boston had reported to the Director of the Trading and Exchange Division that the president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at the resultant depressed prices, when in fact the business was doing exceptionally well. The Rule was drafted and approved on the day this report was received. See Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (remarks of Milton Freeman, one of rule's co-drafters); *Blue Chip Stamps*, *supra*, at 767 (BLACKMUN, J., dissenting). Although adopted pursuant to § 10 (b), the language of the rule appears to have been derived in significant part from § 17 of the 1933 Act, 15 U. S. C. § 77q. *E. g.*, *ibid.*; *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 867 (Friendly, J., concurring). There is no indication in the administrative history of the Rule that any of the subsections was intended to proscribe conduct not involving scienter. Indeed the Commission's release issued contemporaneously with the rule explained:

"The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3230 (May 21, 1942).

That same year, in its Annual Report, the Commission again stated that the purpose of the rule was to protect investors against "fraud":

"During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities,

adopted pursuant to authority granted the Commission under § 10 (b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Dixon v. United States*, 381 U. S. 68, 74 (1965), quoting *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129, 134 (1936). Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10 (b). For the reasons stated above, we think the Commission's original interpretation of Rule 10b-5 was compelled by the language and history of § 10 (b) and related sections of the Acts. See, e. g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1304-1305 (CA2 1973); *SEC v. Texas Gulf Sulphur Co.*, *supra*, at 868; 3 L. Loss, *supra*, 1766; 6 *id.*, at 3883-3885 (Supp. 1969). When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.<sup>22</sup>

while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers." 8 SEC Ann. Rep. 10 (1942).

<sup>22</sup> As we find the language and history of § 10 (b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy," set forth by the parties, that may have influenced the lawmakers in their formulation of the statute. We do note that the standard urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or



## III

Recognizing that § 10 (b) and Rule 10b-5 might be held to require proof of more than negligent misfeasance by Ernst & Ernst as a precondition to the imposition of civil liability, respondents further contend that the case should be remanded for trial under whatever standard is adopted. Throughout the lengthy history of this case respondents have proceeded on a theory of liability premised on negligence, specifically disclaiming that Ernst & Ernst had engaged in fraud or intentional misconduct.<sup>44</sup> In these circumstances, we think it inappropriate to remand the action for further proceedings.

express opinions with respect to matters under the Acts. Last Term, in *Blue Chip Stamps*, *supra*, at 747-748, the Court pertinently observed:

"While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931), Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate cause':

"The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.' *Id.*, at 179-180, 174 N. E., at 444."

This case, on its facts, illustrates the extreme reach of the standard urged by respondents. As investors in transactions initiated by Nay, not First Securities, they were not foreseeable users of the financial statements prepared by Ernst & Ernst. Respondents conceded that they did not rely on either these financial statements or Ernst & Ernst's certificates of opinion. See n. 9, *supra*. The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands in other cases. Acceptance of respondents' view would extend to new frontiers the "hazards" of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress.

<sup>44</sup> See 503 F. 2d, at 1104, 1119; n. 5, *supra*.

The judgment of the Court of Appeals is

*Reversed.*

MR. JUSTICE STEVENS took no part in the consideration or decision of this case.



MAR 11 1976

**FILE COPY**  
PLEASE RETURN  
TO FILE

2nd DRAFT

**SUPREME COURT OF THE UNITED STATES**

No. 74-1042

Ernst & Ernst, Petitioner,	} On Writ of Certiorari to the	
v.		United States Court of Ap-
Olga Hochfelder et al.		peals for the Seventh Cir- cuit.

[March —, 1976]

MR. JUSTICE POWELL delivered the opinion of the Court.

The issue in this case is whether an action for civil damages may lie under § 10 (b) of the Securities Exchange Act of 1934 (1934 Act), 48 Stat. 891, 15 U. S. C. § 78j (b), and Securities and Exchange Commission Rule 10b-5, 17 CFR § 240.10b-5, in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant.

I

Petitioner, Ernst & Ernst, is an accounting firm. From 1946 through 1967 it was retained by First Securities Company of Chicago (First Securities), a small brokerage firm and member of the Midwest Stock Exchange and of the National Association of Securities Dealers, to perform periodic audits of the firm's books and records. In connection with these audits Ernst & Ernst prepared for filing with the Securities and Exchange Commission (the Commission) the annual reports required of First Securities under § 17 (a) of the 1934 Act, 15 U. S. C. § 78q (a).<sup>1</sup> It also prepared for First Securities responses

<sup>1</sup> Section 17 (a) requires that securities brokers or dealers "make . . . and preserve . . . such accounts . . . books, and other

to the financial questionnaires of the Midwest Stock Exchange (the Exchange).

Respondents were customers of First Securities who invested in a fraudulent securities scheme perpetrated by Leston B. Nay, president of the firm and owner of 92% of its stock. Nay induced the respondents to invest funds in "escrow" accounts that he represented would yield a high rate of return. Respondents did so from 1942 through 1966, with the majority of the transactions occurring in the 1950's. In fact, there were no escrow accounts as Nay converted respondents' funds to his own use immediately upon receipt. These transactions were not in the customary form of dealings between First Securities and its customers. The respondents drew their personal checks payable to Nay or a designated bank for his account. No such escrow accounts were reflected on the books and records of First Securities, and none was shown on its periodic accounting to respondents in connection with their other investments. Nor were they included in First Securities' filings with the Commission or the Exchange.

---

records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors." During the period relevant here, Commission Rule 17a-5, 17 CFR § 240.17a-5, required that First Securities file an annual report of its financial condition that included a certificate stating "clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein." See SEC Release No. 3338 (Nov. 28, 1948), X-17A-5 (h). The rule required Ernst & Ernst to state in its certificate, *inter alia*, "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances" and provided that nothing in the rule should "be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit for the purpose of expressing the opinions required" by the rule.



This fraud came to light in 1968 when Nay committed suicide, leaving a note that described First Securities as bankrupt and the escrow accounts as "spurious." Respondents subsequently filed this action<sup>2</sup> for damages against Ernst & Ernst<sup>3</sup> in the United States District Court for the Northern District of Illinois under § 10 (b) of the 1934 Act. The complaint charged that Nay's escrow scheme violated § 10 (b) and Commission Rule 10b-5,<sup>4</sup> and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct proper audits of First Securities. As revealed through discovery, respondents' cause of action rested on a theory of negligent nonfeasance. The premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm said to prevent an effective audit. The practice principally relied on was Nay's rule that only he could open

<sup>2</sup> Two separate, but substantially identical, complaints initially were filed by different members of the present group of respondents. Subsequently the respondents jointly filed a First Amended Complaint. The two cases were treated by the District Court as if they were consolidated and were consolidated formally on appeal.

<sup>3</sup> The first count of the complaint was directed against the Exchange, charging that through its acts and omissions it had aided and abetted Nay's fraud. Summary judgment in favor of the Exchange was affirmed on appeal. *Hochfelder v. Midwest Stock Exchange*, 503 F. 2d 364 (CA7), cert. denied, 419 U. S. 875 (1974).

<sup>4</sup> Immediately after Nay's suicide the Commission commenced receivership proceedings against First Securities. In those proceedings all of the respondents except two asserted claims based on the fraudulent escrow accounts. These claims ultimately were allowed in *SEC v. First Securities Co.*, 463 F. 2d 981, 986 (CA7 1972), cert. denied, 409 U. S. 880 (1973), where the court held that Nay's conduct violated § 10 (b) and Rule 10b-5, and that First Securities was liable for Nay's fraud as an aider and abettor. The question of Ernst & Ernst's liability was not considered in that case.

mail addressed to him at First Securities or addressed to First Securities to his attention, even if it arrived in his absence. Respondents contended that if Ernst & Ernst had conducted a proper audit, it would have discovered this "mail rule." The existence of the rule then would have been disclosed in reports to the Exchange and to the Commission by Ernst & Ernst as an irregular procedure that prevented an effective audit. This would have led to an investigation of Nay that would have revealed the fraudulent scheme. Respondents specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.<sup>3</sup>

After extensive discovery the District Court granted Ernst & Ernst's motion for summary judgment and dismissed the action. The court rejected Ernst & Ernst's contention that a cause of action for aiding and abetting a securities fraud could not be maintained under § 10 (b) and Rule 10b-5 merely on allegations of negligence. It concluded, however, that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audits in accordance with generally accepted auditing standards.<sup>4</sup>

---

<sup>3</sup> In their response to interrogatories in the District Court respondents conceded that they did "not accuse Ernst & Ernst of deliberate, intentional fraud," merely with "inexcusable negligence." App. 81.

<sup>4</sup> The District Court also held respondent's action was barred by the doctrine of equitable estoppel and the applicable Illinois statute of limitations of three years. See n. 29, *infra*. As customers of First Securities respondents were sent confirmation forms as required under § 17 (a) and Rule 17a-5 requesting that they verify the accuracy of the statements and notify Ernst & Ernst as to any exceptions. Although the confirmation forms contained no reference to the escrow accounts, Ernst & Ernst was not notified of this fact. The last audit of First Securities by Ernst & Ernst was completed in December 1967 and the first complaint in this action was not filed until February 1971.



The Court of Appeals for the Seventh Circuit reversed and remanded, holding that one who breaches a duty of inquiry and disclosure owed another is liable in damages for aiding and abetting a third party's violation of Rule 10b-5 if the fraud would have been discovered or prevented but for the breach. 503 F. 2d 1100 (1974).<sup>7</sup> The court reasoned that Ernst & Ernst had a common-law and statutory duty of inquiry into the adequacy of First Securities' internal control system because it had contracted to audit First Securities and to prepare for filing with the Commission the annual report of its financial condition required under § 17 of the 1934 Act and Rule 17a-5, 17 CFR § 240.17a-5.<sup>8</sup> The Court further rea-

<sup>7</sup> In support of this holding, the Court of Appeals cited its decision in *Hochfelder v. Midwest Stock Exchange, supra*, where it detailed the elements necessary to establish a claim under Rule 10b-5 based on a defendant's aiding and abetting a securities fraud solely by inaction. See n. 3 *supra*. In such a case the plaintiff must show "that the party charged with aiding and abetting had knowledge of or, but for the breach of a duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure." *Id.*, at 374. The court explained in the instant case that these "elements constitute a flexible standard of liability which should be amplified according to the peculiarities of each case." 503 F. 2d, at 1104. In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10 (b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the rule, nor the elements necessary to establish such a cause of action. See, e. g., *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 678 (1966), 286 F. Supp. 702 (ND Ind. 1968), *aff'd*, 417 F. 2d 147 (CA7 1969), cert. denied, 397 U. S. 989 (1970) (defendant held liable for giving active and knowing assistance to a third party engaged in violations of the securities laws). See generally Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, 120 U. Pa. L. Rev. 397, 620-645 (1972).

<sup>8</sup> See n. 1, *supra*.

sioned that respondents were beneficiaries of the statutory duty to inquire<sup>9</sup> and the related duty to disclose any material irregularities that were discovered. *Id.*, at 1105-1111. The court concluded that there were genuine issues of fact as to whether Ernst & Ernst's failure to discover and comment upon Nay's mail rule<sup>10</sup> constituted a breach of its duties of inquiry and disclosure, *id.*, at 1111, and whether inquiry and disclosure would have led to the discovery or prevention of Nay's fraud. *Id.*, at 1115.<sup>11</sup>

<sup>9</sup> The court concluded that the duty of inquiry imposed on Ernst & Ernst under § 17 (a) was "grounded on a concern for the protection of investors such as [respondents]," without reaching the question whether the statute imposed a "direct duty" to the respondents. 503 F. 2d, at 1105. The court held that Ernst & Ernst owed no common-law duty of inquiry to respondents arising from its contract with First Securities since Ernst & Ernst did not specifically foresee that respondents' limited class might suffer from a negligent audit, compare *Glanzer v. Shepard*, 233 N. Y. 236, 135 N. E. 275 (1922), with *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931); see, e. g., *R. I. Hospital Trust Nat'l Bank v. Swartz*, 455 F. 2d 847, 851 (CA4 1972). Moreover, respondents conceded that they did not rely on the financial statements and reports prepared by Ernst & Ernst or on its certificate of opinion. 503 F. 2d, at 1107.

<sup>10</sup> In their briefs respondents allude to several other alleged failings by Ernst & Ernst in its audit of First Securities, principally its failure to inquire into the collectibility of certain loans by First Securities to Nay and its failure to follow up on a 1965 memorandum that characterized First Securities' overall system of internal control as weak because of the centralization of functions in the cashier. The Court of Appeals mentioned none of these alleged deficiencies in its opinion in this case, although it did discuss the loans to Nay and certain other related matters in its opinion in *Hochfelder v. Midwest Stock Exchange*, *supra*, at 370-371, holding that the existence of these facts was insufficient to put the Exchange on notice that further inquiry into First Securities' financial affairs was required.

<sup>11</sup> The Court of Appeals also reversed the District Court's holding



We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10 (b) and Rule 10b-5 in the absence of any allegation of "scienter"—intent to deceive, manipulate, or

with respect to equitable estoppel and the statute of limitations. See n. 6, *supra*. In view of our disposition of the case we need not address these issues.

<sup>12</sup> Although the verbal formulations of the standard to be applied have varied, several courts of appeals have held in substance that negligence alone is sufficient for civil liability under § 10 (b) and Rule 10b-5. See, e. g., *White v. Abrams*, 495 F. 2d 724, 730 (CA9 1974) ("flexible duty" standard); *Mysel v. Fields*, 386 F. 2d 718, 735 (CA8 1967), cert. denied, 390 U. S. 951 (1968) (negligence sufficient); *Kohler v. Kohler Co.*, 319 F. 2d 634 (CA7 1963) (knowledge not required). Other courts of appeals have held that some type of scienter—i. e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud—is necessary in such an action. See, e. g., *Clegg v. Conk*, 507 F. 2d 1351, 1351-1352 (CA10 1974), cert. denied, 422 U. S. 1007 (1975) (an element of "scienter or conscious fault"); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1306 (CA2 1973) ("willful or reckless disregard" of the truth). But few of the decisions announcing that some form of negligence suffices for civil liability under § 10 (b) and Rule 10b-5 actually have involved only negligent conduct. *Smallwood v. Pearl Brewing Co.*, 489 F. 2d 579, 606 (CA5), cert. denied, 419 U. S. 879 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 286 (CA3 1972) (Adams, J., concurring); *Bucklo*, *Scienter and Rule 10b-5*, 67 Nw. U. L. Rev. 562, 568-570 (1972).

In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10 (b) and Rule 10b-5.

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

8 ERNST & ERNST v. HOCHFELDER

defraud.<sup>12</sup> 421 U. S. 909 (1975). We conclude that it will not and therefore we reverse.<sup>13</sup>

## II

Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929. The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended 15 U. S. C. § 77a *et seq.*, was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H. R. Rep. No. 85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges. See S. Rep. No. 792, 73d Cong., 2d Sess., 1-5 (1934). Although the Acts contain numerous carefully drawn express civil remedies and criminal penalties, Congress recognized that efficient regulation of securities trading could not be accomplished under a rigid statutory program. As part of the

<sup>12</sup> Respondents further contend that Ernst & Ernst owed them a direct duty under § 17 (a) and Rule 17a-5 of the 1934 Act to conduct a proper audit of First Securities and that they may base a private cause of action against Ernst & Ernst for violation of that duty. Respondents' cause of action, however, was premised solely on the alleged violation of § 10 (b) and Rule 10b-5. During the lengthy history of this litigation they have not amended their original complaint to aver a cause of action under § 17 (a) and Rule 17a-5. We therefore do not consider that a claim of liability under § 17 (a) is properly before us even assuming respondents could assert such a claim independently of § 10 (b).



1934 Act Congress created the Commission, which is provided with an arsenal of flexible enforcement powers. See, e. g., 1933 Act §§ 8, 19, 20, 48 Stat. 79, 85, 86, as amended, 15 U. S. C. §§ 77h, 77e, 77t; 1934 Act §§ 9, 19, 21, 48 Stat. 889, 898, 899, as amended, 15 U. S. C. §§ 78i, 78s, 78u.

Section 10 of the 1934 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." 15 U. S. C. § 78j. In 1942, acting pursuant to the power conferred by § 10 (b), the Commission promulgated Rule 10b-5, which now provides:

"Employment of manipulative and deceptive devices.

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

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

"(2) 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

"(3) 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."

Although § 10 (b) does not by its terms create an express civil remedy for its violation, and there is no

indication that Congress,<sup>14</sup> or the Commission when adopting Rule 10b-5,<sup>15</sup> contemplated such a remedy, the existence of a private cause of action for violations of the statute and the rule is now well established. *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U. S. 128, 150-154 (1972); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U. S. 6, 13 n. 9 (1971). During the 30-year period since a private cause of action was first implied under § 10 (b) and Rule 10b-5,<sup>16</sup> a substantial body of case law and commentary has developed as to its elements. Courts and commentators long have differed with regard to whether scienter is a necessary element of such a cause of action, or whether negligent conduct alone is sufficient.<sup>17</sup> In addressing this question, we turn first to the language of § 10 (b), for "[t]he starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps*, *supra*, at 756 (POWELL, J., concurring); *e. g.*, *FTC v. Bunte Brothers, Inc.*, 312 U. S. 349, 350 (1941).

<sup>14</sup> See, *e. g.*, S. Rep. No. 792, 73d Cong., 2d Sess., 5-6 (1934); Note, Implied Liability Under the Securities Exchange Act, 61 Harv. L. Rev. 858, 860 (1948).

<sup>15</sup> SEC Securities Exchange Release No. 3230 (1942); *Birnbaum v. Newport Steel Corp.*, 193 F. 2d 461, 463 (CA2), cert. denied, 343 U. S. 958 (1952).

<sup>16</sup> *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (ED Pa. 1946).

<sup>17</sup> See cases cited in n. 12, *supra*. Compare, *e. g.*, Comment, Scienter and Rule 10b-5, 69 Col. L. Rev. 1057, 1080-1081 (1969); Note, Negligent Misrepresentations under Rule 10b-5, 32 Chi. L. Rev. 824, 839-844 (1965); Note, 82 Harv. L. Rev. 938, 947 (1969); Note, Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 Yale L. J. 658, 682-689 (1965), with, *e. g.*, 3 L. Loss, Securities Regulation 1766 (2d ed. 1961); 6 *id.*, at 3883-3885 (Supp. 1969).



## A

Section 10 (b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10 (b) was intended to proscribe knowing or intentional misconduct. See *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 868 (CA2 1968) (Friendly, J., concurring), cert. denied *sub nom. Kline v. SEC*, 394 U. S. 976 (1969); Loss, Summary Remarks, 30 Bus. Lawyer 163, 165 (1975). See also *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 280 (CA3 1972) (Adams, J., concurring).

In its *amicus curiae* brief, however, the Commission contends that nothing in the language "manipulative or deceptive device or contrivance" limits its operation to knowing or intentional practices.<sup>18</sup> In support of its view, the Commission cites the overall congressional purpose

<sup>18</sup>The Commission would not permit recovery upon proof of negligence in all cases. In order to harmonize civil liability under § 10 (b) with the express civil remedies contained in the 1933 and 1934 Acts, the Commission would limit the circumstances in which civil liability could be imposed for negligent violation of Rule 10b-5 to situations in which (i) the defendant knew or reasonably could foresee that the plaintiff would rely on his conduct, (ii) the plaintiff did in fact so rely, and (iii) the amount of the plaintiff's damages caused by the defendant's conduct was definite and ascertainable. Brief of *Amicus Curiae* 23-33. The Commission concludes that the present record does not establish these conditions since Ernst & Ernst could not reasonably have foreseen that the financial statements of First Securities would induce respondents to invest in the escrow accounts, respondents in fact did not rely on Ernst & Ernst's audits, and the amount of respondents' damages was unascertainable. *Id.*, 33-36. Respondents accept the Commission's basic analysis of the operative language of the statute and rule, but reject these additional requirements for recovery for negligent violations.

in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them. See *Affiliated Ute Citizens v. United States*, *supra*, at 151; *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U. S., at 11-12; *J. I. Case Co. v. Borak*, 377 U. S. 426, 432-433 (1964). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1963). The Commission then reasons that since the "effect" upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning. See, e. g., *Addison v. Holly Hill Fruit Products, Inc.*, 322 U. S. 607, 617-618 (1944).<sup>19</sup> The argument simply ignores the use of the words "manipulative," "device," and "contrivance," terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence.<sup>20</sup> Use of the

<sup>19</sup> "To let general words draw on some purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another . . . . After all, legislation when not expressed in technical terms is addressed to the common run of men and is therefore understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him." *Addison v. Holly Hill Fruit Products, Inc.*, 322 U. S. 607, 617-618 (1944). See Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Col. L. Rev. 527, 536-537 (1947).

<sup>20</sup> Webster's Int'l Dictionary (2d ed. 1934) defines "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice," and "contrivance" in pertinent part as "[a] thing con-



word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.<sup>21</sup>

In addition to relying upon the Commission's argument with respect to the operative language of the statute, respondents contend that since we are dealing with "remedial legislation," *Tcherepnin v. Knight*, 389 U. S. 332, 336 (1967), it must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens v. United States*, *supra*, at 151, quoting *SEC v. Capital Gains Research Bureau*, *supra*, at 186. They argue that the "remedial purposes" of the Acts demand a construction of § 10 (b) that embraces negligence as a standard of liability. But in seeking to accomplish its broad remedial goals, Congress did not adopt uniformly a negligence standard even as to express civil remedies. In some circumstances and with respect to certain classes of defendants, Congress did create express liability predicated upon a failure to exercise reasonable care. *E. g.*, 1933 Act § 11 (b) (3) (B), 48 Stat. 82 as amended 15 U. S. C. § 77k (b) (3) (B) (liability of "experts," such as accountants, for misleading statements in portions of registration statements for which they are responsible).<sup>22</sup> But in other situations

trived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "[t]o devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme . . . ." The Commission also ignores the use of the terms "[t]o use or employ," language that is supportive of the view that Congress did not intend § 10 (b) to embrace negligent conduct.

<sup>21</sup> Webster's Int'l Dictionary, *supra*, defines "manipulate" as ". . . to manage or treat artfully or fraudulently; as to *manipulate* accounts . . . 4. *Exchanges*. To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig."

<sup>22</sup> See p. 21 & n. 26, *infra*.

good faith is an absolute defense. 1934 Act § 18, 48 Stat. 897, as amended 15 U. S. C. § 78r (misleading statements in any document filed pursuant to the 1934 Act). And in still other circumstances Congress created express liability regardless of the defendant's fault, 1933 Act § 11 (a) (issuer liability for misleading statements in the registration statement).

It is thus evident that Congress fashioned standards of fault in the express civil remedies in the 1933 and 1934 Acts on a particularized basis. Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section. Where, as here, we deal with a judicially implied liability, the statutory language certainly is no less important. In view of the language of § 10 (b) which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its context, *United States v. Oregon*, 366 U. S. 643, 648 (1961); *Packard Motor Car Co. v. NLRB*, 330 U. S. 485, 492 (1947), further inquiry may be unnecessary. We turn now, nevertheless, to the legislative history of the 1934 Act to ascertain whether there is support for the meaning attributed to § 10 (b) by the Commission and respondents.

#### B

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, we think the relevant portions of that history support our conclusion that § 10 (b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.

The original version of what would develop into the 1934 Act was contained in identical bills introduced by



Senator Fletcher and Representative Rayburn. S. 2693, 73d Cong., 2d Sess. (1934); H. R. 7852, 73d Cong., 2d Sess. (1934). Section 9 (c) of the bills, from which present § 10 (b) evolved, proscribed as unlawful the use of "any device or contrivance which, or any device or contrivance in a way or manner which the Commission may by its rules and regulations find detrimental to the public interest or to the proper protection of investors." The other subsections of proposed § 9 listed specific practices that Congress empowered the Commission to regulate through its rulemaking power. See §§ 9 (a) (short sale), (b) ("stop-loss order"). Soon after the hearings on the House bill were held, a substitute bill was introduced in both Houses which abbreviated and modified § 9 (c)'s operative language to read "any manipulative device or contrivance." S. 3420, 73d Cong., 2d Sess., § 10 (b) (1934); H. R. 8720, 73d Cong., 2d Sess., 9 (c) (1934). Still a third bill, retaining the Commission's power to regulate the specific practices enumerated in the prior bills, and omitting all reference to the Commission's authority to prescribe rules concerning manipulative or deceptive devices in general, was introduced and passed in the House. H. R. 9323, 73d Cong., 2d Sess., § 9 (1934). The final language of § 10 is a modified version of a Senate amendment to this last House bill. See H. R. Rep. No. 1838, 73d Cong., 2d Sess., 32-33 (1934) (Conference Report).

Neither the intended scope of § 10 (b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation. There is no indication, however, that § 10 (b) was intended to proscribe conduct not involving scienter. The extensive hearings that preceded passage of the 1934 Act touched only briefly on § 10, and most of the discussion was devoted to the enumerated devices that the

Commission is empowered to proscribe under § 10 (a). The most relevant exposition of the provision that was to become § 10 (b) was by Thomas G. Corcoran, a spokesman for the drafters. Corcoran indicated:

"Subsection (c) [§ 9 (c) of H. R. 7852—later § 10 (b)] says, 'Thou shalt not devise any other cunning devices.' . . .

"Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices."

Hearings on H. R. 7852 and H. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934). This brief explanation of § 10 (b) by a spokesman for its drafters is significant. The section was described rightly as a "catch-all" clause to enable the Commission "to deal with new manipulative [or cunning] devices." It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions.<sup>23</sup> Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing "manipulative [or cunning] devices" to include negligence.<sup>24</sup>

<sup>23</sup> See n. 21, *supra*.

<sup>24</sup> In support of its position the Commission cites statements by Corcoran in the Senate hearings that "in modern society there are many things you have to make crimes which are sheer matters of negligence" and "intent is not necessary for every crime." Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., 6509-6510 (1934). The comments, taken in context, shed no light on the meaning of § 10 (b). Corcoran's remarks were made during a discussion of whether criminal violations could arise under § 8 (a) (3) of S. 2693, 73d Cong., 2d



The legislative reports do not address the scope of § 10 (b) or its catch-all function directly. In considering specific manipulative practices left to Commission regulation, however, the reports indicate that liability would not attach absent scienter, supporting the conclusion that Congress intended no lesser standard under § 10 (b). The Senate Report of S. 3420 discusses gener-

---

Sess., which in material part was incorporated in § 9 of the 1934 Act, 15 U. S. C. § 78i, in the absence of specific intent to influence security prices for personal gain. The remarks, moreover, were not addressed to the scope of § 8, but were general observations concerning activity society might proscribe under criminal law. Ferdinand Pecora, counsel to the committee and a draftsman of S. 2693, *Foremost-McKesson, Inc. v. Provident Securities Co.*, — U. S. —, — n. 24 (1976), described the language as "[e]xcluding from its scope an act that is not done with any ulterior motives or purposes, as set forth in the act." *Id.*, at 8510. Further, prior to the passage of the 1934 Act, proposed § 8 was amended to require willful behavior as a prerequisite to civil liability for violations. Compare § 9 (e) of the 1934 Act with § 8 (c) of S. 2693. See H. R. Rep. No. 1383, 73d Cong., 2d Sess., 21 (1934).

The Commission also relies on objections to a draft version of § 10 (b)—§ 9 (c) of S. 2693 and H. R. 7852, see pp. 14-15, *supra*—raised by representatives of the securities industry in the House and Senate hearings. They warned that the language was so vague that the Commission might outlaw anything. *E. g.*, Hearings on Stock Exchange Practices, *supra*, at 6988; Hearings on H. R. 7852 and H. R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 258 (1934). Remarks of this kind made in the course of legislative debate or hearings other than by persons responsible for the preparation or the drafting of a bill, are entitled to little weight. See, *e. g.*, *United States v. United Mine Workers*, 330 U. S. 255, 276-277 (1947); *United States v. Wrightwood Dairy Co.*, 315 U. S. 110, 125 (1942). This is especially so with regard to the statements of legislative opponents who "[i]n their zeal to defeat a bill . . . understandably tend to overstate its reach." *NLRB v. Fruit Packers*, 377 U. S. 58, 66 (1964). See *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U. S. 384, 394-395 (1951).

ally the various abuses that precipitated the need for the legislation and the inadequacy of self-regulation by the stock exchanges. The Report then analyzes the component provisions of the statute, but does not parse § 10. The only specific reference to § 10 is the following:

"In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10 and 16." S. Rep. 792, 73d Cong., 2d Sess., 6 (1934).

In the portion of the general analysis section of the Report entitled "Manipulative Practices," however, there is a discussion of specific practices that were considered so inimical to the public interest as to require express prohibition, such as "wash" sales and "matched" orders,<sup>22</sup> and of other practices that might in some cases serve legitimate purposes, such as stabilization of security prices and grants of options. *Id.*, at 7-9. These latter practices were left to regulation by the Commission. 1934 Act §§ 9 (a) (6), (c), 48 Stat. 890, 15 U. S. C. §§ 78i (a) (6), (c). Significantly, we think, in the discussion of

<sup>22</sup> "Wash" sales are transactions involving no change in beneficial ownership. "Matched" orders are orders for the purchase/sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security. Section 9 (a) (1) of the 1934 Act, 15 U. S. C. § 78i (a) (1), proscribes wash sales and matched orders when effectuated "[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or . . . with respect to the market for any such security." See *In re J. A. Latimer & Co.*, 38 S. E. C. 790 (1958); *In re Thornton & Co.*, 28 S. E. C. 208 (1948).



the need to regulate even the latter category of practices when they are manipulative, there is no indication that any type of criminal or civil liability is to attach in the absence of scienter. Furthermore, in commenting on the express civil liabilities provided in the 1934 Act, the Report explains:

" . . . if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party. . . . The bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in good faith." *Id.*, at 12-13 (emphasis supplied).

The Report therefore reveals with respect to the specified practices, an overall congressional intent to prevent "manipulative and deceptive practices . . . which fulfill no useful function" and to create private actions for damages stemming from "illicit practices," where the defendant has not acted in good faith. The views expressed in the House Report are consistent with this interpretation. H. Rep. No. 1383, 73d Cong., 2d Sess., 10-11, 20-21 (1934) (H. R. 9323). There is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catch-all provision of § 10 (b) should be interpreted no more broadly.

## C

The 1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities. See *Blue Chip Stamps*, 421 U. S., at 727-730. As the Court indicated in *SEC v. National Securities, Inc.*, 393 U. S. 453 (1969), "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen. . . ." Recognizing this, respondents and the Commission contrast § 10 (b) to other sections of the Acts to support their contention that civil liability may be imposed upon proof of negligent conduct. We think they misconceive the significance of the other provisions of the Acts.

The Commission argues that Congress has been explicit in requiring willful conduct when that was the standard of fault intended, citing § 9 of the 1934 Act, 48 Stat. 889, 15 U. S. C. § 78i, which generally proscribes manipulation of securities prices. Sections 9 (a)(1) and (a)(2), for example, respectively prohibit manipulation of security prices "[f]or the purpose of creating a false or misleading appearance of actual trading in any security . . . or . . . with respect to the market for any such security," and "for the purpose of including the purchase or sale of such security by others." See also § 9 (a)(4). Section 9 (e) then imposes upon "[a]ny person who willfully participates in any act or transaction in violation of" other provisions of § 9 civil liability to anyone who purchased or sold a security at a price affected by the manipulative activities. From this the Commission concludes that since § 10 (b) is not by its terms explicitly restricted to willful, knowing, or purposeful conduct, it should not be construed in all cases to require more than negligent action or inaction as a precondition for civil liability.

The structure of the Acts does not support the Com-



mission's argument. In 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. See 1933 Act, §§ 11, 12, 15, 48 Stat. 82, 84, as amended 15 U. S. C. §§ 77k, 77l, 77o; 1934 Act §§ 9, 18, 20, 48 Stat. 889, 897, 899, as amended 15 U. S. C. §§ 78i, 78r, 78t. For example, § 11 of the 1933 Act unambiguously creates a private action for damages when a registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading. Within the limits specified by § 11 (e), the issuer of the securities is held absolutely liable for any damages resulting from such misstatement or omission. But experts such as accountants who have prepared portions of the registration statement are accorded a "due diligence" defense. In effect, this is a negligence standard. An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that "after reasonable investigation" he had "reasonable ground[s] to believe" that the statements for which he was responsible were true and there was no omission of a material fact.<sup>20</sup> § 11 (b)(3)(B)(i). See, e. g., *Escott v.*

<sup>20</sup> Other individuals who sign the registration statement, directors of the issuer, and the underwriter of the securities similarly are accorded a complete defense against civil liability based on the exercise of reasonable investigation and a reasonable belief that the registration statement was not misleading. §§ 11 (b)(3)(A), (C), (D), (c). See, e. g., *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 575-583 (EDNY 1971) (underwriters, but not officer-directors, established their due diligence defense). See generally R. Jennings & H. Marsh, *Securities Regulation* 1018-1027 (2d ed. 1972), and sources cited therein; Folk, *Civil Liabilities under the Federal Securities Acts: The Barchis Case*, 55 Va. L. Rev. 199 (1969).

*Barchris Construction Corp.*, 283 F. Supp. 643, 697-703 (SDNY 1968). The express recognition of a cause of action premised on negligent behavior in § 11 stands in sharp contrast to the language of § 10 (b), and significantly undercuts the Commission's argument.

We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct, see §§ 11, 12 (2), 15, 15 U.S.C. §§ 77k, 77l, 77o,<sup>27</sup> is subject to significant procedural restrictions not applicable under § 10 (b).<sup>28</sup> Section 11 (e) of the 1933

<sup>27</sup> Section 12 (2) creates potential civil liability for a seller of securities in favor of the purchaser for misleading statements or omissions in connection with the transaction. The seller is exculpated if he proves that he did not know, or in the exercise of reasonable care, could not have known of the untruth or omission. Section 15 of the 1933 Act, as amended by § 208 of Title II of the 1934 Act, makes persons who "control" any person liable under § 11 or § 12 liable jointly and severally to the same extent as the controlled person, unless he "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 15 U.S.C. § 77o. See Act of June 6, 1934, Pub. L. No. 291, c. 404, Title II § 208, 48 Stat. 908.

<sup>28</sup> Each of the provisions of the 1934 Act that expressly create civil liability, except those directed to specific classes of individuals such as directors, officers, or 10% beneficial holders of securities, see § 16 (b), 15 U.S.C. § 78p, *Foremost-McKesson, Inc. v. Provident Securities Co.*, *supra*; *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973), contains a state-of-mind condition requiring something more than negligence. Section 9 creates potential civil liability for any person who "willfully participates" in the manipulation of securities on a national exchange. § 9 (e), 15 U.S.C. § 78i (e). Section 18 creates potential civil liability for misleading statements filed with the Commission, but provides the defendant with the defense that "he acted in good faith and had no knowledge that such statement was false or misleading." 15 U.S.C. § 78r. And § 20, which imposes liability upon "controlling persons" for violations of the Act by those they control, exculpates a defendant who "acted in good faith and did not . . . induce the act . . . ."



Act, for example, authorizes the court to require a plaintiff bringing a suit under § 11, § 12 (2), or § 15 thereof to post a bond for costs, including attorneys' fees and in specified circumstances to assess costs at the conclusion of the litigation. Section 13 specifies a statute of limitations of one year from the time the violation was or should have been discovered, in no event to exceed three years from the time of offer or sale, applicable to actions brought under § 11, § 12 (2), or § 15. These restrictions, significantly, were imposed by amendments to the 1933 Act adopted as part of the 1934 Act. Prior to amendment § 11 (e) contained no provision for payment of costs. 48 Stat. 83. Act of May 27, 1933, Pub. L. No. 22, c. 38, Title I, § 11 (e). See Act of June 6, 1934, Pub. L. No. 291, c. 404, Title II § 206 (e), 48 Stat. 908. The amendments also substantially shortened the statute of limitations provided by § 13. Compare Pub. L. No. 22, *supra*, § 13, 48 Stat. 84, with 15 U. S. C. § 77m. See 1934 Act, § 207, 48 Stat. 908. We think these procedural limitations indicate that the judicially created private damage remedy under § 10 (b)—which has no comparable restrictions<sup>29</sup>—cannot be

constituting the violation. . . ." 15 U. S. C. § 78t. Emphasizing the important difference between the operative language and purpose of § 14 (a) of the 1934 Act, 15 U. S. C. § 14n (a), as contrasted with § 10 (b), however, some courts have concluded that proof of scienter is unnecessary in an action for damages by the shareholder recipients of a materially misleading proxy statement against the issuer corporation. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Kohn v. American Metal Climax, Inc.*, *supra*, at 289-290.

*cf.*

<sup>29</sup> Since no statute of limitations is provided for civil actions under § 10 (b), the law of limitations of the forum state is followed as in other cases of judicially implied remedies. See *Holmberg v. Armbricht*, 327 U. S. 392, 395 (1946), and cases cited therein. Although it is not always certain which state statute of limitations should be followed, such statutes of limitations usually are longer

extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by § 11, § 12 (2), and § 15 to be brought instead under § 10 (b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.<sup>30</sup> See, e. g., *Fischman v. Raytheon Manufacturing Co.*, 188 F. 2d 783, 786-787 (CA2 1951); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 867-868 (Friendly, J., concurring); *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123, 124 (ED Pa. 1948); 3 L. Loss, *Securities Regulation* 1787-1788 (2d ed. 1961); R. Jennings & H. Marsh, *Securities Regulation* 1070-1074 (3d ed. 1972). We would be unwilling to bring about this result absent substantial support in the legislative history, and there is none.<sup>31</sup>

than the period provided under § 13. 3 L. Loss, *supra*, at 1773-1774. As to costs see n. 30 *infra*.

<sup>30</sup> Congress regarded these restrictions on private damage actions as significant. In introducing Title II of the 1934 Act, Senator Fletcher indicated that the amendment to § 11 (e) of the 1933 Act, providing for potential payment of costs, including attorneys' fees, "is the most important [amendment] of all." 78 Cong. Rec. 8669. One of its purposes was to deter actions brought solely for their potential settlement value. See *ibid.*; H. Rep. 1838, 73d Cong., 2d Sess., 42 (1934) (Conference Report); *Blue Chip Stamps, supra*, at 740-741. This deterrent is lacking in the § 10 (b) context, in which a district court's power to award attorneys' fees is sharply circumscribed. See *Alaska Pipeline Service Co. v. Wilderness Society*, 421 U. S. 240 (1975) ("bad faith" requirement); *F. D. Rich Co. v. Industrial Lumber Co.*, 417 U. S. 116, 129 (1974).

<sup>31</sup> Section 18 of the 1934 Act creates a private cause of action against persons, such as accountants, who "make or cause to be made" materially misleading statements in reports or other documents filed with the Commission. 15 U. S. C. § 78r. We need not consider the question whether a cause of action may be maintained under § 10 (b) on the basis of actions that would constitute a violation of § 18. Under § 18 liability extends to persons who, in reliance on such statements, purchased or sold a security whose price



## D

We have addressed, to this point, primarily the language and history of § 10 (b). The Commission contends, however, that subsections (2) and (3) of Rule 10b-5 are cast in language which—if standing alone—could encompass both intentional and negligent behavior. These subsections respectively provide that it is unlawful “[t]o 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 light of the circumstances under which they were made, not misleading . . .” and “to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . .” Viewed in isolation the language of subsection (2), and arguably that of subsection (3), could be read as proscribing, respectively, any type of material misstatement or omission, and any

was affected by the statements. Liability is limited, however, in the important respect that the defendant is accorded the defense that he acted in “good faith and had no knowledge that such statement was false or misleading.” Consistent with this language the legislative history of the section suggests something more than negligence on the part of the defendant is required for recovery. The original version of § 18 (a), § 17 (a) of S. 2693, H. R. 7852 and H. R. 7855, see pp. 14-15, *supra*, provided that the defendant would not be liable if “he acted in good faith and in the exercise of reasonable care had no ground to believe that such statement was false or misleading.” The accounting profession objected to this provision on the ground that liability would be created for honest errors in judgment. See Senate Hearings on Stock Exchange Practices, *supra*, at 7176-7183; House Hearings on H. R. 7852 and H. R. 8720, *supra*, at 653. In subsequent drafts the current formulation was adopted. It is also significant that actions under § 18 are limited by a relatively short statute of limitations similar to that provided in § 13 of the 1933 Act. § 18 (c). Moreover, as under § 11 (e) of the 1933 Act the District Court is authorized to require the plaintiff to post a bond for costs, including attorney’s fees, and to assess such costs at the conclusion of the litigation. § 18 (a).

course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not.

We note first that such a reading cannot be harmonized with the administrative history of the rule, a history making clear that when the Commission adopted the rule it was intended to apply only to activities that involved scienter.<sup>22</sup> More importantly, Rule 10b-5 was

---

<sup>22</sup> Apparently the rule was a hastily drafted response to a situation clearly involving intentional misconduct. The Commission's Regional Administrator in Boston had reported to the Director of the Trading and Exchange Division that the president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at the resultant depressed prices, when in fact the business was doing exceptionally well. The Rule was drafted and approved on the day this report was received. See Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (remarks of Milton Freeman, one of rule's co-drafters); *Blue Chip Stamps, supra*, at 767 (BLACKMUN, J., dissenting). Although adopted pursuant to § 10 (b), the language of the rule appears to have been derived in significant part from § 17 of the 1933 Act, 15 U. S. C. § 77q. *E. g.*, *ibid.*; *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d, at 867 (Friendly, J., concurring). There is no indication in the administrative history of the Rule that any of the subsections was intended to proscribe conduct not involving scienter. Indeed the Commission's release issued contemporaneously with the rule explained:

"The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3230 (May 21, 1942).

That same year, in its Annual Report, the Commission again stated that the purpose of the rule was to protect investors against "fraud":

"During the fiscal year the Commission adopted Rule X-10B-5 as an additional protection to investors. The new rule prohibits fraud by any person in connection with the purchase of securities,



adopted pursuant to authority granted the Commission under § 10 (b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." *Dixon v. United States*, 381 U. S. 68, 74 (1965), quoting *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129, 134 (1936). Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10 (b). For the reasons stated above, we think the Commission's original interpretation of Rule 10b-5 was compelled by the language and history of § 10 (b) and related sections of the Acts. See, e. g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281, 1299 (CA2 1973); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1304-1305 (CA2 1973); *SEC v. Texas Gulf Sulphur Co.*, *supra*, at 868; 3 L. Loss, *supra*, 1766; 6 *id.*, at 3883-3885 (Supp. 1969). When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct.<sup>24</sup>

while the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers." 8 SEC Ann. Rep. 10 (1942).

<sup>24</sup> As we find the language and history of § 10 (b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy," set forth by the parties, that may have influenced the lawmakers in their formulation of the statute. We do note that the standard urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or

## III

Recognizing that § 10 (b) and Rule 10b-5 might be held to require proof of more than negligent misfeasance by Ernst & Ernst as a precondition to the imposition of civil liability, respondents further contend that the case should be remanded for trial under whatever standard is adopted. Throughout the lengthy history of this case respondents have proceeded on a theory of liability premised on negligence, specifically disclaiming that Ernst & Ernst had engaged in fraud or intentional misconduct.<sup>44</sup> In these circumstances, we think it inappropriate to remand the action for further proceedings.

express opinions with respect to matters under the Acts. Last Term, in *Blue Chip Stamps*, *supra*, at 747-748, the Court pertinently observed:

"While much of the development of the law of deceit has been the elimination of artificial barriers to recovery on just claims, we are not the first court to express concern that the inexorable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good. In *Ultramares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931), Chief Judge Cardozo observed with respect to 'a liability in an indeterminate amount for an indeterminate time to an indeterminate cause':

"The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.' *Id.*, at 179-180, 174 N. E., at 444."

This case, on its facts, illustrates the extreme reach of the standard urged by respondents. As investors in transactions initiated by Nay, not First Securities, they were not foreseeable users of the financial statements prepared by Ernst & Ernst. Respondents conceded that they did not rely on either those financial statements or Ernst & Ernst's certificates of opinion. See n. 9, *supra*. The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands in other cases. Acceptance of respondents' view would extend to new frontiers the "hazards" of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress.

<sup>44</sup> See 503 F. 2d, at 1104, 1119; n. 5, *supra*.



The judgment of the Court of Appeals is

*Reversed.*

MR. JUSTICE STEVENS took no part in the consideration or decision of this case.