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"Fraud" and Civil Liability under the Federal Securities Laws

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"FRAUD" AND CIVIL LIABILITY UNDER THE FEDERAL SECURITIES LAWS

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TABLE OF CONTENTS

INTRODUCTION

The Securities and Exchange Commission (SEC) functions under eight related but separate statutes:

(1) The Securities Act of 1933 (1933 act) requires the registration, on a disclosure philosophy, of distributions (public offerings) of securities (section 5).

(2) The Securities Exchange Act of 1934 (1934 act), the most significant of the series, is addressed to postdistribution trading. That statute requires the separate registration of (a) any security that is listed on a stock exchange and (b) any "equity security" that is issued by a company with gross assets of $1 million or more (recently raised to $3 million by SEC exemptive rule) and held of record by at least five hundred persons (section 12). Registered securities are subject to certain reporting, proxy solicitation, insider trading, and tender offer provisions (sections 13, 14, 16). There is also a registration and regulatory scheme for brokers and dealers, supplemented to a considerable extent by a system of self-regulation--through the registered stock exchanges, the National Association of Securities Dealers, Inc. (with respect to the over-the-counter market), the registered clearing agencies, and the Municipal Securities Rulemaking Board--under the general aegis of the SEC. As part of this scheme, margin rules are promulgated by the Board of

Governors of the Federal Research System but enforced by the SEC.

(3) The Public Utility Holding Company Act of 1935 (1935 act) pervasively regulates electric and gas holding companies and their subsidiaries in order to ensure compliance with the statutory standards of geographical integration and corporate simplification.

(4) The Trust Indenture Act of 1939 (1939 act) supplements the 1933 act when a distribution consists of debt securities. A trust indenture with specified provisions must be qualified with the SEC, and there must be an independent corporate trustee.

(5) The Investment Company Act of 1940 is a complex regulatory scheme for the investment company industry.

(6) The Investment Advisers Act of 1940 requires the registration of investment advisers and regulates a few of their practices.

(7) The Securities Investor Protection Act of 1970 (1970 act) insures customers against their brokers' insolvency up to specified amounts by requiring every registered broker or dealer to be a member of (and pay assessments to) the Securities Investor Protection Corporation (SIPC). The SIPC, though not a government agency, was created by Congress and operates under some supervision by the SEC.

(8) Finally, under chapter 11 of the bankruptcy statute, the SEC serves as adviser to the court in corporate reorganization proceedings in which there is a substantial public interest.[1]

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1. Aside from the bankruptcy statute (11 U.S.C.), all these

The American Law Institute's proposed Federal Securities Code (the Code)--which was approved also by the American Bar Association and, with some relatively insubstantial changes, by both the "Carter Commission" and the "Reagan Commission"--would integrate all these statutes except chapter 11 and also codify a good deal of the case law as well as the administrative rules and practices.[2] Although there is no immediate prospect of the Code's being introduced in Congress, the courts have been treating it as a sort of restatement in the areas of "fraud" and civil liability, where the law is primarily judge-made to begin with.[3]

For present purposes four of the eight statutes may be disregarded--the bankruptcy statute and the 1970 act for obvious reasons, the 1939 act because it has seen very little litigation, and the 1935 act because the commission, having long since comcompleted the huge task of reorganizing and simplifying the nation's public utility holding company structure, has recently recommended the statute's repeal. This leaves--in order of volume

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acts appear in 15 U.S.C., but are usually cited by statute and section number:

1933 act	15 U.S.C. § 77a et seq.
1934 act	15 U.S.C. § 78a et seq.
1935 act	15 U.S.C. § 79 et seq.
1939 act	15 U.S.C. § 77aaa et seq.
Inv. Co. Act	15 U.S.C. § 80a-1 et seq.
Inv. Adv. Act	15 U.S.C. § 80b-1 et seq.
1970 act	15 U.S.C. § 78aaa et seq.

2. Published in two volumes, with extensive commentary, as ALI, Federal Securities Code (1980 & 2d Supp. 1981).

3. Cf., e.g., SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983) (en banc).

of litigation--the 1934 and 1933 acts and the two 1940 acts.

The "fraud" and civil liability aspects of these statutes, which will be discussed in chapters 1 and 2, respectively, of this essay, are not coterminous, but they do substantially overlap. On the one hand, some of the civil liability provisions have nothing to do with fraud, notably section 12(1) of the 1933 act, which imposes strict liability for violation of the registration requirement. On the other hand, the fraud provisions give rise to public as well as private proceedings; consequently, their substantive aspects (for example, the treatment of scienter under rule 10b-5) will be considered in chapter 1, and questions that are unique to private proceedings (reliance, causation, and relief available) will be treated in chapter 2.[4]

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4. Chapters 1 and 2 appear in considerably expanded form as chapters 9 and 10 of L. Loss, Fundamentals of Securities Regulation, which was published in June 1983.

I. "FRAUD"

A. Common Law and SEC "Fraud"

1. The Weapons in the Federal Arsenal

There are more than a dozen overlapping statutory provisions and rules, which have been the subject of highly variegated amounts of litigation.

(1) On the criminal side, the mail and wire fraud statutes, as well as the conspiracy statute, are frequently used in conjunction with the fraud provisions in the securities statutes.[5]

(2) Section 17(a) of the 1933 act, the "model" provision, creates three separate offenses:

> It shall be unlawful for any person in the offer or sale of any security by the use of any means or instruments of

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5. 18 U.S.C. §§ 1341, 1343, 1371. _See_ Edwards v. United States, 312 U.S. 473, 483-84 (1941).

Another statute that will bear watching is "RICO," so called from the title of chapter 96 of the Criminal Code, 18 U.S.C. §§ 1961-68 (1970): Racketeer Influenced and Corrupt Organizations. That statute defines "racketeering activity" to include "fraud in the sale of securities." 18 U.S.C. § 1961. _See generally_ United States v. Turkette, 452 U.S. 576 (1981); Atkinson, _"Racketeer Influenced and Corrupt Organizations," 18 U.S.C. §§ 1961-68: Broadest of the Federal Criminal Statutes_, 69 J. Crim. L. & Criminology 2 (1978).

RICO also has a civil side, with provision not only for treble damages but also for such extraordinary relief as divestiture and reorganization. 18 U.S.C. § 1964(a), (c). In general, _see_ Long, _Treble Damages for Violations of the Federal Securities Laws: A Suggested Analysis and Application of the RICO Civil Cause of Action_, 85 Dick. L. Rev. 201 (1981); Pickholz & Friedman, _Civil RICO Actions_, 14 Rev. Sec. Reg. 965 (1981).

transportation or communication in interstate commerce or by the use of the mails, directly or indirectly--

> (1) to employ any device, scheme, or artifice to defraud, or
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> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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 transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

This section marked an advance over the mail fraud statute in a number of respects: (a) It is specifically tailored to the securities field. (b) The 1933 act affords the civil remedy of injunction, thus making it possible to nip certain types of fraud in the bud rather than to rely exclusively on criminal prosecution after the deed. (c) Clause (2) does not refer to "fraud" as such, but speaks in terms of material misstatements and half-truths.

(3) In 1934 the Securities Exchange Act added two relevant provisions, sections 9(a)(4) and 10(b). The former, part of the section 9 attack on market manipulation, makes it unlawful for any

> dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to make, regarding any security registered on a national securities exchange, for the purpose of inducing the purchase or sale of such security, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

Section 9(a)(4) is self-operative but limited to registered

securities. Section 10(b), on the other hand, is an omnibus section that is not so limited but is not self-operative either:

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

(4) In 1936 the 1934 act was amended by adding what is the present section 15(c)(1):

> No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance.

This section differs from section 10(b) in a number of respects: (a) Although it directs the commission to adopt rules of definition, the first portion of the section (in contrast to section 10(b)) is literally self-operative.[6] (b) It is limited to over-the-counter (as distinct from exchange) transactions. (c) It is limited to transactions by brokers or dealers. However, like

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6. In practice, section 15(c)(1) has not been treated as self-operative. The basic rule under that section, rule 15cl-2, is modeled on clauses (2) and (3) of section 17(a) of the 1933 act, except that the portion comparable to clause (2) applies only when the "statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading."

However, like section 10(b) and unlike section 17(a), it covers fraud in the purchase as well as the sale of securities.[7]

(5) With section 10(b) non-self-operative, the combination of section 17(a) of the 1933 act and sections 9(a)(4) and 15(c)(1) of the 1934 act left a lacuna with respect to fraud in the purchase of securities by persons other than (a) brokers and dealers acting over the counter or (b) persons buying registered securities for the purpose of inducing their purchase by others. This was a serious gap because an issuer itself, or an officer or director or controlling stockholder, could buy in its own securities by fraudulent practices (of commission as well as omission) without being touched by federal authority except for criminal prosecution under the mail or wire fraud statute. The commission's solution to this problem was the adoption in 1942 of rule 10b-5 (originally designated X-10B-5 as the fifth rule under section 10(b)), which merely borrowed the language of section 17(a), except for the reference in clause (2) to obtaining money or property by means of an untrue statement or half-truth, and applied it "in connection with the purchase or sale of any security":

> 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,

7. See also section 15(c)(2), enacted in 1938, which is similar to section 15(c)(1) except that (a) it does not apply to an "exempted security," (b) it covers "fictitious quotations" as well as fraudulent, deceptive, or manipulative practices, and (c) it directs the commission by rule to "prescribe means reasonably designed to prevent" such practices and quotations as well as to define them.

> (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.

Apart from these provisions and rules relating to purchases or sales, there are a number of others that are more specialized:

(6) Section 14(a) of the 1934 act makes it unlawful, in the broadest terms, for any person to solicit a proxy in respect of any registered security (that is to say, a security registered under that act) "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." Rule 14a-9, adopted under that section, prohibits any solicitation,

> written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

The reference to correcting earlier statements that have become false or misleading is unique.[8]

8. Section 14(c) is an analogous provision that requires an "information statement" in substitution for a "proxy statement" when proxies are not solicited; and rule 14c-6 replicates rule 14a-9.

(7) Section 14(e) of the 1934 act--part of the Williams Act amendments of 1968 with respect to tender offers--is a general antifraud provision in connection with any solicitation in opposition to or in favor of a tender offer. In effect, it "applies rule 10b-5 both to the offeror and to the opposition--very likely, except perhaps for any bearing it may have on the issue of standing, only a codification of existing case law" under rule 10b-5.[9] And section 13(e) makes it unlawful for an issuer to buy any of its own equity securities in contravention of commission rules adopted to define, and "to prescribe means reasonably designed to prevent," practices that are "fraudulent, deceptive, or manipulative." In contrast to section 14(e), section 13(e) applies only to an issuer that has a class of registered securities or that is a closed-end investment company registered under the Investment Company Act.

(8) Section 17(j) of the Investment Company Act authorizes the commission, again, to "define, and prescribe means reasonably designed to prevent, . . . fraudulent, deceptive or manipulative acts" by persons in specified relationships to registered investment companies <u>in connection with their portfolio securities</u>.

(9) Section 206 of the Investment Advisers Act is, as far as investment advisers are concerned, a cross between the language of 1933 act section 17(a)(1) and (3) and that of 1934 act section

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9. Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 940-41 (2d Cir. 1969).

10(b), with the addition of a rulemaking authority similar to that in 1934 act section 13(e).

<u>2. The Relation between SEC "Fraud" Concepts and Common-Law Deceit</u>

By now a number of general propositions are so well established under these federal fraud provisions as to require little citation of authority here:

(1) The provisions are not limited to common-law deceit.

(2) As the Code codifies the case law, "fact" includes "(A) a promise, prediction, estimate, projection, or forecast, or (B) a statement of intention, motive, opinion, or law."[10] It is almost obligatory in this connection to quote Lord Bowen's observation that "[t]he state of a man's mind is as much a fact as the state of his digestion."[11]

(3) A fact is "material" if "there is a substantial likelihood that a reasonable [person] would consider it important in" determining his choice of action.[12]

(4) The section 17(a)(2) formulation, wherever it appears, is limited to misstatements or half-truths; it does not literally impose an affirmative obligation to speak. We shall notice later

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10. § 202(55).

11. Edgington v. Fitzmaurice, 29 Ch. D. 459, 483 (1885).

12. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). This case was decided under rule 14a-9, the proxy fraud rule. But the definition has been followed in other contexts. <u>E.g.</u>, Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 647 (3d Cir. 1980) (rule 10b-5).

the development of special fraud doctrines based on implied representations in certain circumstances. But otherwise clause (2) of section 17(a), with its requirement that some statement be made, may not go so far in some cases as clauses (1) and (3), under which a scheme to defraud may perhaps more readily be based on silence when there is a duty to speak.

(5) There is another respect in which clause (2) of section 17(a) is narrower than clauses (1) and (3). It is a specific element of an offense under clause (2) that the seller actually "obtain money or property by means of" the false statement or half-truth (though this is not true, as we have seen, of rule 10b-5). By contrast, clause (3) refers to a transaction, practice, or course of business that operates "or would operate" as a fraud or deceit upon the purchaser. And it is clear that the establishment of a "scheme . . . to defraud" under clause (1) is not dependent on proof that any victim suffered actual loss. In other words, it is irrelevant whether the scheme succeeded or failed.

(6) There is little, if anything, left of the "puffing" concept in the securities field.

(7) The extent to which the SEC "fraud" provisions require scienter, and what it means when it is required, are considered in connection with the rule 10b-5 saga, to which we now turn.

B. Corporate "Insiders" (Rule 10b-5)

1. Introduction to Rule 10b-5

It is difficult to think of another instance in the *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little. Justice Rehnquist has aptly referred to rule 10b-5 as a "judicial oak which has grown from little more than a legislative acorn."[13] All that the commission wanted in adopting the rule was a handle for investigating and obtaining injunctive relief against insiders who were buying their company's stock. Civil liability was the function of the Third Branch, aided and abetted, to be sure, by the commission's frequent appearances as amicus curiae.

The law thus made is, of course, federal: the "federal common law" of which Judge Friendly and others have spoken as forming a penumbra around every federal statute.[14] Indeed, it is this emancipation from state law that undoubtedly accounts for "the 10b-5 revolution." For most judges in the second half of the twentieth century seem to view the so-called majority rule at common law--a rule that holds a director to the standard of a fiduciary when he is dealing with the corporation, which is only a *persona ficta*, a ghost, but not when he is dealing with the flesh-and-blood persons who are his constituents--as a monument

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

14. Friendly, *In Praise of Erie--and of the New Federal Common Law*, 19 Rec. A.B. City N.Y. 64 (1964), *reprinted with minor changes in* 39 N.Y.U. L. Rev. 383 (1964); *see also* Friendly, *The Gap in Lawmaking--Judges Who Can't and Legislators Who Won't*, 63 Colum. L. Rev. 787 (1963); Note, *Exceptions to Erie v. Tompkins: The Survival of Federal Common Law*, 59 Harv. L. Rev. 966 (1946).

to the ability of lawyers to hypnotize themselves with their own fictions.

We shall notice something of a counterrevolution as the Supreme Court belatedly awoke in the seventies to the rapid growth of the oak tree under the tender nursing of the lower courts. But analysis reveals that those cases are not cataclysmic.

2. "Disclose or Abstain"

Rule 10b-5, like section 17(a) of the Securities Act, is not limited to corporate insiders--however that term may be defined. The rule may be invoked whenever any person, insider or outsider, indulges in fraudulent practices, misstatements, or half-truths in connection with the purchase or sale of securities. However, it is in the application of rule 10b-5 to purchases by silent corporate insiders that most of the special problems have arisen. The typical pattern is a purchase by a corporate insider (or by the issuer itself) without disclosure of relevant financial data or other information indicating that the security is worth considerably more than it appears to be worth on the basis of market value or whatever information may be available to theseller (or, conversely, an insider's sale without disclosure of unfavorable information).

As far as insiders are concerned, it does not seem too much to say today that rule 10b-5 imposes not merely an obligation (which even one dealing at arm's length has) to refrain from material misstatements or half-truths, but a fiduciary's affirmative obligation to disclose material facts when buying securities from or selling them to security holders. The judicial literature is sparse concerning the underlying rationale of the rule, but there seem to be three mutually supporting theories:

(1) At least when the insider's identity is not hidden, and in the absence of countervailing representations, clause (2) of the rule may be invoked on the basis of an implied representation flowing from the insider's fiduciary obligation to his stockholder constituents, or at any rate from the "special circumstances" that satisfied the Supreme Court in pre-*Erie* and pre-SEC days,[15] that the insider has performed his duty and has not withheld any material inside information.[16]

(2) By analogy to certain developments with respect to broker-dealer fraud concepts that are examined later, the insider's offer to buy or sell at a fixed price might be considered to constitute an implied representation, again under clause (2), that within reasonable limits the stated price represents the insider's judgment of the value of the security.

15. Strong v. Repide, 213 U.S. 419 (1909).

16. This theory wears a bit thin as applied to debt securities, or even with respect to stock when the insider sells to one not already a stockholder. It begs the question, of course, to observe that section 10(b) and the rule apply universally. But they do, for what it is worth. Moreover, the Supreme Court has said, in a bankruptcy context, that a majority stockholder is bound by the "fiduciary standards of conduct which he owes the corporation, its stockholders and creditors" (emphasis supplied). Pepper v. Litton, 308 U.S. 295, 311 (1939). And the securities cases reflect judicial impatience with any buyer-seller distinction in the duty to disclose. SEC v. Murphy, 626 F.2d 633, 652 n.23 (9th Cir. 1980); *cf.* Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951), *cert. denied*, 341 U.S. 920.

(3) Since section 10(b) is part of a statute designed to raise the morals of the marketplace, and in view of the consensus that the SEC fraud provisions are not limited to common-law deceit, perhaps the most honest approach is to say simply that the insider's conduct may be considered fraudulent or deceptive within clauses (1) and (3) of the rule.

Whatever the theory, the statement of the insider's duty in the alternative, "to disclose or abstain," comes down typically to a duty to abstain; for conflict is inevitable between the director's 10b-5 duty to the other party to disclose material facts and the common-law duty he normally owes to the company _not_ to make premature disclosure.

Are insiders safe, then, if they simply refrain from trading when material information is undisclosed? It seems quite clear that a company and its responsible insiders can violate the rule by disseminating _false_ information even though neither the company nor any insider does any trading.[17] But material information may be _temporarily_ withheld from the market when there are good business reasons, so long as neither the issuer nor insiders trade.[18] Whether there is a _greater_ duty to disclose to the marketplace by way of correcting an earlier statement that has become misleading in a material respect represents a hard question; the cases point to a general duty to correct.[19]

17. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 861-63 (2d Cir. 1968), _cert. denied sub nom_. Coates v. SEC and Kline v. SEC, 394 U.S. 976.

18. Dolgow v. Anderson, 438 F.2d 825, 829 (2d Cir. 1970); Investors Management Co., 44 SEC 633, 646 (1971).

3. Who Is an "Insider"?

Since there is no evidence that Congress was thinking of insiders specifically when it enacted section 10(b), the courts have had to decide precisely what persons should have an affirmative duty to disclose; and that group is loosely called "insiders."

In connection with its codification of a good deal of the 10b-5 jurisprudence, the Code, in section 1603(b), defines "insider" in a manner thought to represent existing case law:

> For purposes of section 1603, "insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person who, by virtue of his relationship or former relationship to the issuer, knows a material fact about the issuer or the security in question that is not generally available, or (4) a person who learns such a fact from a person within section 1603(b) (including a person within section 1603(b)(4)) with knowledge that the person from whom he learns the fact is such a person, unless the Commission or a court finds that it would be inequitable on consideration of the circumstances and the purposes of this Code (including the deterrent effect of liability), to treat the person within section 1603(b)(4) as if he were within section 1603(b)(1), (2), or (3).

Clause (3) and to some extent clause (2) are addressed to the problem of the "tippee," and clause (4) goes to the tippee's tippee.[20] Tippees come in many shapes and sizes. Suffice it to

19. _E.g._, SEC v. Shattuck Denn Mining Corp., 297 F. Supp. 470, 475-76 (S.D.N.Y. 1968); _cf_. United States v. Natelli, 527 F.2d 311, 319 (2d Cir. 1975), _cert. denied_, 425 U.S. 934.

20. Cady, Roberts & Co., 40 SEC 907 (1961); _cf_. Jackson v. Smith, 254 U.S. 586, 588-89 (1921); ALI, Restatement of Restitution § 201(2). It has been suggested that "[t]ipping because it

say here that the rule is violated by both the nontrading tipper[21] and his trading tippee.[22] But this rubric applies only when the nonpublic information comes directly or indirectly from the issuer of the securities traded. Thus in Chiarella v. United States the Supreme Court reversed the conviction of an employee of a financial printing house who had managed to figure out the names of several companies that were the targets of tender offers delivered for typesetting with the names blank.[23]

The majority of the Court declined to consider a theory approved by four justices because it had not been taken into account in instructing the jury: that it suffices to show a breach of fiduciary duty to a third person, in that case the defendant's employer. Meanwhile the commission is pressing that theory.[24] And it has resorted to its rulemaking authority in section 14(e)[25] to get at tender offerors' tippees who buy target companies' stock.[26]

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involves a more widespread imbalance of information presents an even greater threat to the integrity of the marketplace than simple insider trading." Fridrich v. Bradford, 542 F.2d 307, 327 n.12 (6th Cir. 1976) (concurring opinion), cert. denied, 429 U.S. 1053.

21. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968), cert. denied sub nom. Coates v. SEC and Kline v. SEC, 394 U.S. 976.

22. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (both tipper and tippee).

23. 445 U.S. 222 (1980).

24. Cf. United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

25. See supra p. 10.

26. Rule 14e-3(a).

4. Scienter

In common-law deceit, scienter has been variously defined to mean everything from knowing falsity with an implication of mens rea, through the various gradations of recklessness, down to such nonaction as is virtually equivalent to negligence or even liability without fault (and were better treated as creating a distinct species of liability not based on intent).[27] In the context of criminal actions under section 17(a)(1), as well as the mail and wire fraud statutes, the term has taken on a coloration of recklessness.[28] In Ernst & Ernst v. Hochfelder, the Court held that scienter was implicit even in the misstatement language of the second clause of rule 10b-5.[29]

That interpretation is logical enough--although a few circuits had previously been satisfied with negligent misstatement--because the rulemaking authority in section 10(b) itself is limited to "manipulative or deceptive" conduct. It is harder to understand why, in construing a statutory provision that was de-

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27. "Where a party innocently misrepresents a material fact by mistake . . . such representation will support an action for fraud." Stein v. Treger, 182 F.2d 696, 699 (D.C. Cir. 1950), and cases cited; see also, e.g., Mears v. Accomac Banking Co., 160 Va. 311, 321, 168 S.E. 740, 743 (1933). It is said that a majority of the states now permit actions on the basis of negligent or sometimes innocent misrepresentation. See Prosser, Handbook of the Law of Torts 699-714 (4th ed. 1971).

28. See United States v. Henderson, 446 F.2d 960, 966 (8th Cir. 1971), cert. denied, 404 U.S. 991 ("reckless disregard" of the facts); United States v. Mackay, 491 F.2d 616, 623 (10th Cir. 1973), cert. denied, 416 U.S. 972, 419 U.S. 1047 (mail fraud statute).

29. 425 U.S. 185 (1976).

signed to raise the standards of the marketplace, the majority opinion reached back in history to the strictest common-law definition: not merely knowing falsity but "intent to deceive, manipulate, or defraud."

What is even more strange is the Court's assaying any definition of scienter when all it had to hold was that the mere negligence alleged in the complaint did not suffice, at least against an accounting firm sued as aider and abettor of its client's violation. The Court, in a footnote, did invite the lower courts to consider whether "recklessness" might not suffice "in some circumstances."[30] The courts have accepted the invitation. But, on the meaning of recklessness, about all that can be said with confidence is that "the standard falls somewhere between intent and negligence."[31]

The Supreme Court has held also that *Hochfelder* governs in SEC injunctive actions (and presumably private actions to the extent they are implied, as well as administrative proceedings) under rule 10b-5 and also clause (1) of section 17(a). However, since section 17(a) is a statutory provision, not a rule that must be interpreted in the light of the rulemaking authority, scienter is not required under the language of clause (2) or

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30. *Id.* at 193 n.12.

31. Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 n.36 (6th Cir. 1979). *E.g.*, *compare* Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977) (closer to "intent minus" than "negligence plus"), *with* Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978) ("carelessness approaching indifference").

(3).[32] This kind of fragmentation, inevitable under today's disjointed fraud provisions, is yet another argument for the integrated treatment of fraud in the Code.

5. Violation of Rule 10b-5 by Nonverbal Acts

One's activities (indeed, one's silence under circumstances giving him a duty to speak) may violate the first and third clauses, as we have seen.[33]

Essentially under this heading, there are several "man bites dog" cases in which customers were held to have defrauded their brokers--notably a recent criminal case in the Supreme Court involving a short-selling customer who had no intention to deliver if the market went up.[34] It follows, moreover, that the fraud need not relate to the investment value of the securities but may go to the consideration given for them.[35]

6. The Rule's Universality

Section 10(b) applies to all transactions, "whether conducted in the organized markets or face-to-face."[36] The plain-

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32. Aaron v. SEC, 446 U.S. 680 (1980).

33. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972).

34. United States v. Naftalin, 441 U.S. 768 (1979).

35. Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1026, 1028 (6th Cir. 1979).

36. Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); *but see* the concurring

tiff does, of course, have to prove that the prohibited conduct was effected, in the language of section 10(b), "by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange." But it is "well established" that "the jurisdictional hook need not be large to fish for securities law violations."[37]

7. "In Connection with a Purchase or Sale"

A good deal of the difficulty with the "in connection with" phrase is traceable to Justice Douglas's reference in the first Supreme Court case under rule 10b-5 (involving an incredibly complicated fraud in which an insurance company was bought with its own assets) to the plaintiff's having "suffered an injury as a result of deceptive practices touching its sale of securities as an investor"[38]--although there is no reason to believe that the justice's use of "touching" was anything more than his variation of "in connection with" as a matter of literary style. Certain things, however, are reasonably clear.

First: As the Court there held, "the fact that creditors of the defrauded corporate buyer or seller of securities may be the ultimate victims does not warrant disregard of the corporate

opinion of Posner, J., in Trecker v. Scag, 679 F.2d 703, 710-12 (7th Cir. 1982).

37. Lawrence v. SEC, 398 F.2d 276, 278 (1st Cir. 1968); but cf. United States v. Maze, 414 U.S. 395 (1974).

38. Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971).

entity."[39] And misappropriation of the proceeds of a sale of securities may be a fraudulent act creating liability for the misappropriator if "the seller was duped into believing that it, the seller, would receive the proceeds,"[40] even though the sale was for full value and the misappropriator was neither a buyer nor a seller.

Second: A fraud is not "in connection with" a purchase or sale if the purchaser or seller was aware of the facts when he bought or sold.[41]

Third: The rule may be violated by feeding misinformation into the marketplace or even by withholding information too long, without any buying or selling. This we have already noticed.[42]

Fourth: The plaintiff, however, does have to be a buyer or seller. This is the famous Birnbaum doctrine, from a 1952 Second Circuit holding to the effect that noncontrolling stockholders could not complain that they had not been given an opportunity to sell to a third person on the controlling stockholders' terms.[43] And in 1975 the Supreme Court in the Blue Chip Stamps case affirmed the doctrine on different facts.[44] However, in the twenty-

39. Id. at 12.

40. Id. at 9.

41. Shivers v. Amerco, 670 F.2d 826, 829-30 (9th Cir. 1982).

42. See supra text at note 17; Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

43. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956.

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

three years between Birnbaum and Blue Chip, the courts put a high gloss on what constitutes a "purchase" or "sale." For example:

(1) In stockholders' derivative actions it is the corporation, not the plaintiff, that must have bought or sold.[45]

(2) The Second Circuit did not apply Birnbaum in private injunctive actions.[46]

(3) Since an issuance of securities involves a 10b-5 "sale" and "purchase,"[47] and many if not most derivative actions involve a security transaction to which the corporation is a party, a good deal of the corporate mismanagement area is opened up to federal law.

(4) The "forced seller" in a "short-form merger" is a "seller" under rule 10b-5.[48] And this is true a fortiori with respect to an ordinary merger in which the stockholders have a vote; on this point there is Supreme Court precedent antedating Blue Chip.[49] This means that rule 10b-5 is available to attack

45. Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970) (a company is a "purchaser" entitled to damages for harmful acts already committed in furtherance of a merger plan not yet consummated).

46. Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967) (stockholders complained that others had been forced to sell out cheaply by insiders' having manipulated the market and kept dividends down); see also Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir. 1970).

47. Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960); Rochelle v. Marine Midland Grace Trust Co. of N.Y., 535 F.2d 523, 527-28 (9th Cir. 1976) (debentures).

48. Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967).

49. SEC v. National Sec., Inc., 393 U.S. 453 (1969); but cf.

proxy literature for a merger when rule 14a-9, the proxy fraud rule, is unavailable because the security is not registered.

(5) Quite clearly a pledgor is a "seller" and a pledgee is a "purchaser."[50]

8. Corporate Mismanagement: The "New Fraud" Theory and Its Demise

Two seemingly self-evident, but not readily reconcilable, propositions have been repeated in judicial utterances: (a) Congress "did not seek to regulate transactions which constitute no more than internal corporate mismanagement."[51] (b) The mere fact that the sale or purchase transaction "was part of a broader scheme of corporate mismanagement" does not preclude an action under rule 10b-5.[52]

This second proposition led to a 1968 en banc opinion in the Second Circuit, Schoenbaum v. Firstbrook,[53] whose language persuaded some commentators that the court had propounded a "new fraud" theory of rule 10b-5: that inadequate (some said "grossly

Rathbone v. Rathbone, 683 F.2d 914 (5th Cir. 1982) (a mere "transfer between corporate pockets").

50. Rubin v. United States, 449 U.S. 424 (1981).

51. Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); see also Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952) (using the phrase "fraudulent mismanagement").

52. Herpich v. Wallace, 430 F.2d 792, 808 (5th Cir. 1970); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974).

53. 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906.

unfair") price coupled with controlling influence was enough to establish a violation regardless of disclosure.[54] But the next Second Circuit case resulted in the demise of a doctrine that probably never was: The Supreme Court in Santa Fe Industries, Inc. v. Green found no support for the proposition "that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule."[55] Justice White in the course of his majority opinion reflected a reluctance "to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[56]

Six months later, a sharply divided panel of the Second Circuit did not read Santa Fe as ruling "that no action lies under rule 10b-5 when a controlling corporation causes a partly owned subsidiary to sell its securities to the parent in a fraudulent transaction and fails to make a disclosure or, as can be alleged here, makes a misleading disclosure,"[57] which was the situation

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54. See, e.g., Note, The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases, 86 Harv. L. Rev. 1007 (1973).

55. 430 U.S. 462, 476 (1977).

56. Id. at 479.

57. Goldberg v. Meridor, 547 F.2d 209 (2d Cir. 1977) (emphasis supplied); see also Wright v. Heizer Corp., 560 F.2d 236, 245-46 (7th Cir. 1977); Kidwell ex rel. Penfold v. Meikle, 597 F.2d 1273, 1294 (9th Cir. 1979); Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602, 610-11 (3d Cir. 1980). On the several approaches followed in

in Schoenbaum but not in Santa Fe. This is not to say that it is enough to allege nondisclosure merely of impure motive or culpability.[58]

Urged on perhaps by Professor Cary's "race to the bottom" criticism of the Delaware Supreme Court,[59] that court and other state courts have reacted to Santa Fe's reminder that questions of fairness, business purpose, and breach of fiduciary duty in "squeeze-out" mergers are matters of state law.[60]

C. Brokers, Dealers, and Investment Advisers

Section 17(a) of the 1933 act, rule 10b-5, and section 9(a)(4) of the 1934 act, as well as the proxy and tender offer fraud provisions (rule 14a-9 and section 14(e)), apply to broker-dealers along with everybody else.[61] But over-the-counter broker-dealers, as we have already noticed, are subject in addition to section 15(c)(1) and (2) of the 1934 act and a batch

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these cases, see Comment, Causation in Rule 10b-5 Actions for Corporate Mismanagement, 48 U. Chi. L. Rev. 936 (1981).

58. Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co., 606 F.2d 602, 610 (5th Cir. 1979); Panter v. Marshall Field & Co., 646 F.2d 271, 290-91 (7th Cir. 1981).

59. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L.J. 663 (1974).

60. Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), partially overruled in Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Perl v. IU Int'l Corp., 61 Hawaii 622, 640, 607 P.2d 1036, 1046 (1980); Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975); see also Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir. 1974) (Georgia law).

61. See Dirks v. SEC, 681 F.2d 824, 833 (D.C. Cir.), cert. granted, 103 S. Ct. 371 (1982).

of rules under those provisions.[62] Moreover, a number of special fraud concepts have been developed in connection with brokers and dealers.

1. The "Shingle Theory"

As a device for limiting excessive spreads (profits) taken by dealers purporting to act as principals (rather than brokers) in the over-the-counter market, the commission developed in a series of administrative proceedings, and the Second Circuit early blessed,[63] the so-called shingle theory: When a dealer hangs out his "shingle" to do business, he impliedly states that he will deal fairly with his customers; and it is an incident of that implied statement that his prices will be reasonably related to the current market. Consequently, if he omits to state that his prices are not reasonably related to the market (which, of course, he cannot realistically say), he omits to state a material fact necessary to make the statement implied from his shingle not misleading, in violation of the several fraud provisions.

The potentialities of this theory--question-begging but effective and no longer challenged--are not exhausted by using it as a basis for an implied representation of pricing reasonably

62. See supra pp. 7-8.

63. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786; cf. Sanders v. John Nuveen & Co., 524 F.2d 1064, 1070 (7th Cir. 1975) (an underwriter impliedly represents "that he has met the standards of his profession in his investigation of the issuer"; Russell L. Irish, 42 SEC 735, 740-42 (1965), aff'd sub nom. Irish v. SEC, 367 F.2d 637 (9th Cir. 1966), cert. denied, 386 U.S. 911.

related to the market. A dealer's "shingle" carries an implied representation, for example, that the dealer will execute only authorized transactions;[64] that he will fill orders promptly;[65] and that he is able to meet his obligations as they mature. On this last basis, the commission almost routinely shuts down broker-dealers that are discovered (usually through a routine inspection) to be insolvent or undercapitalized by moving for a preliminary injunction (sometimes an ex parte restraining order) under the fraud provisions and asking the court to appoint a receiver by way of ancillary relief.[66]

2. Certain Dealers Treated as Agents

Concurrently with the development of the shingle theory, the commission began exploring the status of a broker-dealer who, although purporting to act as principal rather than agent, places himself in a position of trust and confidence with his customer. Such a broker-dealer, the commission declared, is under a much stricter obligation than merely to refrain from taking excessive markups over the current market. His duty as a fiduciary selling his own property to his principal, or buying from his principal for his own account, is to make a scrupulously full disclosure of every element of his adverse interest in the transaction. Like

64. First Anchorage Corp., 34 SEC 299 (1952).

65. DeMarco v. Edens, 390 F.2d 836, 840 (2d Cir. 1968).

66. E.g., SEC v. Wencke, 577 F.2d 619, 623 (9th Cir. 1978), cert. denied, 439 U.S. 964.

the shingle theory, this doctrine culminated in a commission opinion that was sustained on judicial review[67]--though the teaching, of course, is much older.[68]

3. Duty to Investigate and the Suitability Doctrine

More recently, in an evolution from ethical precept to law that is still far from complete, the commission (with some help from the courts) has been refining its "shingle" and "fair dealing" concepts into something that approaches a "suitability" requirement--an obligation on the part of the dealer to recommend only securities that are suitable to the needs of the particular customer.

The development began as an attack on the evils of high-pressure selling, mainly via the long-distance telephone--which is to say, the "boiler room," so called because of the high pressure generated in the selling effort"[69]--and gained support from the holdings that salesmen may not rely blindly on information furnished by the broker-dealer that employs them or by the issuer, especially in the case of a promotional issue.[70] Meanwhile the National Association of Securities Dealers, Inc. (NASD) (organ-

67. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949).

68. "No man can serve two masters." Matt. 6:24.

69. United States v. Rollnick, 91 F.2d 911, 915 (2d Cir. 1937).

70. Hanley v. SEC, 415 F.2d 589, 595-97 (2d Cir. 1969); Mac Robbins & Co., 41 SEC 116, 128-29 (1962), aff'd sub nom. Berko v. SEC, 316 F.2d 137, 142-43 (2d Cir. 1963).

ized in 1939 and the only organization registered with the SEC as a "national securities association" under the newly enacted section 15A of the 1934 act in order to function as a self-regulatory organization for the over-the-counter industry) has always had a suitability rule on its books;[71] and the New York Stock Exchange's "know your customer" rule is being pulled in the same direction.[72]

The switch from ethics to law has two bases:

(1) Since section 15(b)(9) of the 1934 act until its amendment in June 1983 prohibited brokers or dealers who were not members of the NASD from effecting over-the-counter transactions in contravention of commission rules designed (inter alia) "to promote just and equitable principles of trade"--that is to say, rules comparable to those the NASD is required to impose on its members--the commission in 1967 adopted its own suitability rule for those broker-dealers who were subject to section 15(b)(9).[73] Presumably this rule will be rescinded, but it was influential while it was on the books.

(2) In a common-law deceit action that came to the Ninth Circuit under Hawaii law--an action involving the sale of insurance rather than securities--the court held that an insurance agent who had induced the plaintiff to purchase excessive amounts

71. Rules of Fair Practice, art. III, § 2, NASD Manual (CCH) ¶ 2152; Gerald M. Greenberg, 40 SEC 133, 137-38 (1960).

72. Rule 405, N.Y.S.E. Guide (CCH) ¶ 2405; see also rule 411, Am. Stock Ex. Guide (CCH) ¶ 9431.

73. Rule 15b10-3.

of bank-financed insurance was liable because of his false representation that what he was selling "was a suitable program for plaintiff and his family and fitted their needs."[74]

4. Fraud by Investment Advisers

Section 206 of the Investment Advisers Act makes it unlawful for any investment adviser, by use of the mails or interstate facilities, directly or indirectly "(1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . . [or] (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," with rulemaking authority under clause (4), as in section 15(c)(2) of the 1934 act, to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

The first two clauses are modeled on clauses (1) and (3) of the 1933 act; the substantive portion of the fourth clause is modeled on section 10(b) of the 1934 act; and the rulemaking authority is modeled on section 15(c)(2) of the 1934 act.[75]

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74. Anderson v. Knox, 297 F.2d 702, 705 (9th Cir. 1961), cert. denied, 370 U.S. 915; cf. Steadman v. McConnell, 149 Cal. App. 2d 334, 308 P.2d 361 (1957); Hardt v. Brink, 192 F. Supp. 879 (W.D. Wash. 1961); Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 890 (D. Conn. 1976).

75. See supra note 7.

Consequently, everything that has been said thus far in this chapter applies with equal force to investment advisers mutatis mutandis.

The great case under the Investment Advisers Act is SEC v. Capital Gains Research Bureau, Inc., an injunction action decided by the Supreme Court in 1963.[76] In six instances the advisory firm took a long position in a listed stock on the New York Stock Exchange shortly before sending its approximately five thousand subscribers one of its "Special Recommendations" or "Special Bulletins" containing a financial analysis of the particular company, without disclosing the firm's position or intention. In each case there was a small market rise and the firm within a few days sold its stock at a profit. There was also one instance of a short position followed by converse activity. The practice is known on Wall Street as "scalping."

In a broad opinion, the Court (only Justice Harlan dissenting) held that "[i]t would defeat the manifest purpose" of the statute to hold that Congress "intended to require proof of intent to injure and actual injury to clients"; that the content of common-law fraud has not remained static; that fraud also has a broader meaning in equity than at law in that an intention to defraud or misrepresent is not a necessary element in equity; that, "even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law of fraud

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76. 375 U.S. 180 (1963).

in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law 'remedially' as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arms-length transactions involving land and ordinary chattels"; and that the omission of something like clause (2) of section 17(a) of the 1933 act "does not seem significant."

It remains to be seen how much of this will turn out to survive Aaron, the 1980 decision that requires scienter in an injunctive action under rule 10b-5.[77] The Court there distinguished Capital Gains on the basis essentially of "the delicate fiduciary nature of an investment advisory relationship" and the disparate legislative history of sections 10(b) and 206.

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77. Aaron v. SEC, 446 U.S. 680 (1980); see supra text at note 32.

II. CIVIL LIABILITY

The civil liabilities (express and implied) under the SEC statutes are even more variegated--and reflect even more overlapping--than the fraud provisions. First we shall consider the specific liabilities by categories. Then we shall look at the development of the implied liabilities. Finally, we shall touch on two matters that are common to both express and implied liabilities--secondary liability and statutes of limitations.

A. Violation of Registration or Prospectus Provisions of the 1933 Act (Section 12(1))

Section 12(1) can afford to be brief when it provides that "[a]ny person who offers or sells a security in violation of section 5 shall be liable to the person purchasing such security from him" because the liability is virtually absolute. The theory, of course, is deterrence, not restitution. The plaintiff need allege and prove only (a) that the defendant was a seller; (b) that the mails or some means of transportation or communication in interstate commerce was used, not just in connection with the offering of the security generally but in the offer or sale to the particular plaintiff;[78] (c) that the defendant failed to

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78. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 694 n.19 (5th Cir. 1971).

comply with either the registration or the prospectus requirement; (d) that the action is not barred by the statute of limitations; and (e) that adequate tender was made when the plaintiff is seeking rescission.

The only defense then available to the defendant is to allege and prove that the particular security or transaction was exempt from section 5. The seller's intent and his knowledge of the violation, though they may be relevant to an administrative or criminal proceeding or perhaps even a commission action for injunction based on the violation, are entirely irrelevant in an action under section 12(1). Moreover, an illegal offer followed by a legal sale is actionable,[79] as is an illegal delivery, even though section 12(1) refers only to one who "offers or sells" in violation of section 5.[80]

It seems clear in statutory context that, when the plaintiff in section 12 no longer owns the security, damages are to be measured so as to result in the substantial equivalent of rescission--namely, the difference between the purchase price and the plaintiff's resale price (plus interest) less any income or return of capital (with interest) that the plaintiff received on the security.[81]

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79. Diskin v. Lomasney & Co., 452 F.2d 871, 876 (2d Cir. 1971).

80. Repass v. Rees, 174 F. Supp. 898, 903 (D. Colo. 1959); see also Schillner v. H. Vaughan Clarke & Co., 134 F.2d 875, 878 (2d Cir. 1943) (dictum).

81. Cady v. Murphy, 113 F.2d 988, 991 (1st Cir. 1940), cert.

B. Misstatement or Omission in Sale of Securities

1. Generally (Section 12(2))

Section 12(2) is, in effect, a federal variation on the themes of equitable rescission and common-law deceit:

> Any person who offers or sells a security (whether or not exempted by the provision of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

(1) To start with what is clearest, the section applies to all sales of securities, whether or not registered and whether or not the particular security or transaction is exempted from section 5, with one exception: securities exempted under section 3(a)(2), which in substance are those of the federal, state, and local governments, banks, and interests in certain bank common trust funds and tax-exempt plans.

(2) As with section 12(1), section 12(2) applies even when the only use of the mails or interstate facilities is in making delivery.[82]

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denied, 311 U.S. 705; Foster v. Financial Technology, Inc., 517 F.2d 1068, 1071 (9th Cir. 1975).

82. Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953),

(3) The plaintiff does not have to prove "reliance" on the misstatement or omission; he must show only that he did not know of it, which is presumably a lesser burden.[83] The common-law rule that contributory negligence is no defense carries over to section 12(2).[84] And the plaintiff, however sophisticated, has no duty to investigate beyond applying his general knowledge.[85]

(4) On the other hand, the due-care defense makes section 12(2) less favorable for the plaintiff who seeks only rescission than an equitable rescission action, where there is no defense at all once the plaintiff proves a misstatement of a material fact on which he relied.

(5) The section does not impose liability for omissions per se as distinct from half-truths. Here again, however, the section presumably goes at least as far as the common law in imposing an affirmative duty to speak in special situations, as when the seller occupies a fiduciary relationship to the buyer; in such cases the "statements" referred to in the section take

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cert. dismissed, 347 U.S. 925 (1954); Creswell-Keith, Inc. v. Willingham, 264 F.2d 76, 82 (8th Cir. 1959) (mails were used only in buyer's remittances of checks to defendant's creditors as part of the purchase price). Contra Kemper v. Lohnes, 173 F.2d 44, 46 (7th Cir. 1949).

83. Wigand v. Flo-Tek, Inc., 609 F.2d 1028, 1034 (2d Cir. 1979).

84. American Bank & Trust Co. in Munroe v. Joste, 323 F. Supp. 843, 847 (W.D. La. 1970).

85. Sanders v. John Nuveen & Co., 619 F.2d 1222, 1229 (7th Cir. 1980), cert. denied, 450 U.S. 1005; cf. ALI, Restatement (Second) of Torts §§ 540-41.

the form (as we have seen) of implied representations flowing from the special circumstances.[86]

2. Misstatement or Omission in Registration Statement (Section 11)

Section 11 was the bete noire that was going to stifle legitimate financing--and that did not produce a substantial recovery for thirty years. The scant litigation history aside, we must have a look at the elements of the action.[87]

(a) Plaintiffs. Suit may be brought by any person who acquired a registered security, whether in the process of distribution or in the open market. All he must prove is that "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." The plaintiff is spared any concern about reliance (at least insofar as it is divorced from materiality) unless he bought after the issuer had made generally available to its security holders an earnings statement covering a period of at least a year beginning after the effective date; but even then "reliance may be established without proof of the reading of the registration statement by such person."[88] And instead of the plaintiff's having to prove

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86. See supra pp. 28-29.

87. See Cherner v. Transitron Elec. Corp., 221 F. Supp. 48 (D. Mass. 1963); Escott v. BarChris Constr. Co., 283 F. Supp. 643 (S.D.N.Y. 1968); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

88. § 11(a), last paragraph.

causation, damages are reduced to the extent that the defendant proves that they did not result from his misconduct[89]--what might be called "comparative causation with a reverse twist."[90]

These defenses, sounding variously in negligence, are a substitute for the scienter of common-law deceit, with the burden of going forward on the defendants.[91] And in abandoning privity, the "revolutionary" change that Chief Judge Cardozo (as he then was) referred to in the famous Ultramares case has now been "wrought by legislation" as he said it would have to be.[92] Section 11 goes as far in protecting purchasers of securities as the New York Court of Appeals there refused to go at common law in protecting creditors who had relied on a certified balance sheet negligently prepared by accountants for an insolvent borrower. Indeed, it goes further in putting the burden on the accountant (or other expert) to show affirmatively that he made a reasonable investigation and had reasonable ground to believe and did believe that the "expertized" statements were true and that there was no omission of a material fact.

(b) Defendants. There is a wide variety of potential defen-

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89. § 11(e).

90. See Collins v. Signetics Corp., 605 F.2d 110, 114 (3d Cir. 1979). In Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 586 (E.D.N.Y. 1971), the court took judicial notice of "the very drastic general decline in the stock market in 1969" and adjusted the damage figure accordingly.

91. § 11(a)(1)-(5).

92. Ultramares Corp. v. Touche, 255 N.Y. 170, 187, 174 N.E. 441, 447 (1931).

dants: (a) every person who signed the registration statement, which is to say under section 6(a), the issuer itself, "its principal executive officer or officers, its principal financial officer, its comptroller or principal accounting officer," and in the case of a foreign or "territorial" issuer "its duly authorized representative in the United States"; (b) every person who was a director (or person performing similar functions) of the issuer or a partner in the issuer "at the time of the filing of the part of the registration statement with respect to which his liability is asserted"; (c) every person who with his consent was named in the statement as about to assume any such position; (d) every accountant, engineer, appraiser, or other expert named in the statement with his consent, but only to the extent of liability concerning any part of the statement or any related report or valuation prepared or certified by him; and (e) every underwriter. In addition, section 15 reaches anyone whom the plaintiff can show to be in control of any of these persons.[93]

One person not covered is the plaintiff's immediate seller as such (notably the retail dealer in a distribution) unless he is an "underwriter." That is the function of section 12(2), along with its covering exempted securities and transactions.

The issuer's liability is absolute with but one exception: It has the defense, available to all defendants, of showing that the plaintiff knew of the untruth or omission at the time of his

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93. See infra pp. 59-60.

acquisition of the security. For other defendants an elaborate series of reasonable-care defenses is substituted for scienter, notably:

(1) A nonexpert defendant (which is to say a director, officer, or underwriter), as well as an expert sued on his "expertized" portion of the registration statement, might establish that "he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective," that it was true and complete.[94] And the standard of reasonableness was changed in 1934--largely for psychological reasons, so it seems--from "that required of a person occupying a fiduciary relationship" to "that required of a prudent man in the management of his own property."[95]

(2) A nonexpert defendant sued on an "expertized" portion of the registration statement has a somewhat readier, double-negative defense: that "he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[96]

Section 11(e) incorporates a modified "tort measure" of damages--in the main, purchase price less value at the time of suit rather than delivery.

94. § 11(b)(3)(A)-(B).

95. § 11(c).

96. § 11(b)(3)(C).

C. Miscellaneous Statutory Liabilities

First: Section 29(b) of the 1934 act and its counterparts in the two 1940 acts provide that every contract made in violation of the statute or any rule thereunder, as well as every contract whose performance would involve such a violation, is "void" as regards the rights of (a) any violator and (b) any person, not a party to the contract, who acquires any right thereunder with actual knowledge of the facts resulting in the violation.[97] Insofar as these provisions may be used defensively, it cannot be assumed that all contracts involving a violation are unenforceable.[98] But these provisions may also be used offensively to obtain rescission of consummated contracts, as we shall see in the discussion of implied liabilities.

Second: Space prevents more than mention of the famous section 16(b) of the 1934 act,[99] on the recapture from directors and officers, as well as more-than-ten-percent equity holders, of short-term (less-than-six-months) trading profits in registered

97. Inv. Co. Act. § 47(b); Inv. Adv. Act § 215(b); see also Pub. Util. Holding Co. Act § 26(b).

98. Compare A.C. Frost & Co. v. Coeur d'Alene Mines Corp., 312 U.S. 38 (1941), with Kaiser-Frazer Corp. v. Otis & Co., 195 F.2d 838, 844 (2d Cir. 1952), cert. denied, 344 U.S. 856.

99. See also Pub. Util. Holding Co. Act § 17(b); Inv. Co. Act § 30(f).

equity securities of their issuers. This section has spawned an elaborate jurisprudence.[100]

Third: Sections 9(e) and 18 of the 1934 act--which cover, respectively, market manipulation and false filing with respect to registered securities--may be mentioned together because the elements of both sections are so strict that they have been virtually dead letters.[101] The reported cases involve the extent to which those sections may be bypassed by resort to implied actions under rule 10b-5.[102]

D. Implied Liabilities

1. Recent Supreme Court Cases

Until a number of recent Supreme Court cases, most of the rich structure of express liabilities, especially in the 1933 and 1934 acts, was overshadowed by the wide recognition of implied liabilities. After an overview of those cases--not all of them involving the SEC statutes by any means--we shall try to ascertain the present status of the most important implied liabilities in the light of the Supreme Court's teaching.

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100. See cases cited in L. Loss, Fundamentals of Securities Regulation ch. 7F (1983); Blau v. Lehman, 368 U.S. 403, 409 (1962) (dictum that one who "deputizes" another to be his director is himself a director); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) (merger); Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976) (purchase that puts one over the 10 percent line is not covered).

101. See also section 18's satellites in section 16(a) of the 1935 act and section 323(a) of the 1939 act.

102. See infra text at note 136.

The first implied action under any SEC provision to get to the Court was J.I. Case Co. v. Borak in 1964, and it involved the use of the proxy fraud rule, rule 14a-9, to attack a corporate merger. An opinion by Justice Clark for a unanimous Court was hailed by commentators as laying down a new basis for implying a private action: "Private enforcement of the proxy rules provides a necessary supplement to Commission action."[103]

It was fairly predictable that the Court one day would have to rationalize Borak in more traditional terms--presumably the doctrine in tort law that recognizes, in effect, that a violation of a legislative provision that "protects a class of persons" may give a right of action to a member of the class.[104] The Court's 1971 recognition of an implied action under rule 10b-5 did not help so far as underlying theory is concerned, because Justice Douglas contented himself with a note that all the circuits had so held.[105]

A number of skirmishes led in 1975 to Cort v. Ash, where the Court seemed to be going out of its way to provide guidance to bench and bar.[106] Rejecting a private right of action for violation of a criminal statute prohibiting corporate contributions in

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103. 377 U.S. 426, 432 (1964).

104. ALI, Restatement (Second) of Torts § 874A; see also §§ 285(a), 286-88C.

105. Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

106. 422 U.S. 66 (1975).

presidential elections,[107] Justice Brennan for a unanimous Court laid down four relevant factors:[108] (a) Is the plaintiff "one of the class for whose especial benefit the statute was enacted?"--in short, the traditional tort theory. (b) Is there "any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one?" (c) Is it "consistent with the underlying legislative scheme to imply such a remedy for the plaintiff?" (d) Is "the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"

Two years later, in Piper v. Chris-Craft Industries, Inc., the Court relied on this analysis to reject an implied action for damages under section 14(e) of the 1934 act, the tender offer fraud provision, and rule 10b-6, an antimanipulation rule that prohibits purchases during distributions.[109] After another two years, however, Cannon v. University of Chicago (a non-SEC case), which came out the other way on a Cort analysis strongly flavored by the civil rights context, shattered Cort's unanimity.[110] Six justices implied a private right of action under section 901(a) of title IX of the Education Amendments of 1972, which prohibits

107. 18 U.S.C. § 610.

108. 422 U.S. at 78.

109. 430 U.S. 1 (1977).

110. 441 U.S. 677 (1979).

discrimination on the basis of sex under any education program receiving federal assistance. But Justice Stevens for the majority adjured Congress to be specific in the future. Justice Rehnquist, though joining the majority opinion, apprised "the lawmaking branch . . . that the ball, so to speak, may well now be in its court," to the point where the Court "in the future should be extremely reluctant to imply a cause of action."[111] And Justice Powell, pointing to no fewer than twenty appellate decisions that had implied private actions from federal statutes in the four years since Cort v. Ash, and ignoring the fact that the idea of implying civil liability from violation of statutes was part of the English common law at least as far back as the beginning of the eighteenth century,[112] concluded that that case was an unconstitutional encroachment on the separation of powers.[113]

The Court decided two more securities cases in 1979: In Touche Ross & Co. v. Redington it held that section 17(a) of the 1934 act, which requires registered brokers to file reports with the SEC, could not be the basis of a customer's action for damages against the broker's auditing firm on an allegation of state

111. Id. at 718.

112. H. Street, The Law of Torts 265 n.4 (6th ed. 1976); see, e.g., Couch v. Steel, 3 El. & Bl. 402, 411, 118 Eng. Rep. 1193, 1196 (Q.B. 1854), cited in Texas & Pac. Ry. Co. v. Rigsby, 241 U.S. 33, 40 (1916); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825, 1837-38 (1982).

113. 441 U.S. at 730.

misstatements in the reports.[114] In Transamerica Mortgage Advisors, Inc. v. Lewis[115] the Court refused to imply an action for damages under the fraud provision of the Investment Advisers Act, section 206,[116] but did permit a rescission action on behalf of a client under the voidability provision, section 215.[117] Finally, among other Supreme Court cases outside the SEC field, one that is particularly noteworthy is Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran,[118] where the Court held in 1982 that the lower courts' routine recognition of an implied action for violation of the Commodity Exchange Act pointed to a legislative intent that that view should survive the comprehensive amendments of 1974, which created the Commodity Futures Trading Commission.

With some trepidation one may assay a summary of where all this Supreme Court activity leaves the matter of implied liability under the SEC legislation:

(1) It seems fairly clear that Cort, though still used has been weakened, at least to the extent that its third and fourth factors (consistency with the statutory scheme and impact on state law) are irrelevant unless the second factor (legislative intent)--together perhaps with the first (whether the plaintiff

114. 442 U.S. 560 (1979).

115. 444 U.S. 11 (1979).

116. See supra pp. 10-11.

117. See supra p. 43.

118. 102 S. Ct. 1825 (1982).

is a member of a class meant to be especially benefited)--points to an affirmative conclusion.[119]

(2) Suppose Congress wants civil liability but prefers to delegate the job of working out the nuances to the courts. For example, both of the legislative reports on the Small Business Investment Incentive Act of 1980[120] emphasized the value of private rights of action as a necessary adjunct to the SEC's enforcement efforts as well as providing a compensatory function; the reports also made it plain that the courts were expected to recognize private rights of action under the legislation, since they "would be consistent with and further Congress' intent in enacting [the particular] provision, and . . . such actions would not improperly occupy an area traditionally the concern of state law."[121] So even under Justice Powell's constitutional view, a formula exists for affording judicial flexibility without at the same time offending article III. That view seems to have picked up three more justices.[122]

(3) The Transamerica case under the Investment Advisers Act makes it crystal clear that the voidability provisions in the 1934, 1935, and 1940 acts may be used by the innocent party of-

119. California v. Sierra Club, 451 U.S. 287, 297 (1981).

120. 94 Stat. 2274 (1980), amending Inv. Co. Act.

121. H.R. Rep. No. 1341, 96th Cong. 28-29 (1980); S. Rep. No. 958, 96th Cong. 14 (1980).

122. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825, 1848 (1982) (dissenting opinion of Powell, J.).

fensively to achieve rescission, not merely defensively to defeat enforcement of the contract. This is at least three-quarters of a loaf, and one whose aroma seems pleasing to all nine justices. Indeed, it is arguable even in the face of Transamerica that section 29(b) of the 1934 act makes the whole loaf available--damages as well as rescission--because it alone of the four voidability provisions contains a statute of limitations, inserted in 1936 along with the enactment of what is now section 15(c)(1), with respect to the voiding of any contract for violation of that section "in any action maintained in reliance on" section 29(b).

(4) The approach of Borak does seem quite dead, except perhaps in cases based on civil rights legislation or directly on the Constitution.[123] But the holding of Borak was "grandfathered" in by Touche Ross & Co. v. Redington because of its ancient lineage.[124] So were the 10b-5 cases, although the proxy rules could readily have been distinguished as displacing virtually no state law. At the same time, a majority of the Court in the Piper case was unwilling to extend Borak's holding to the closely related form of corporate warfare by tender offer rather than by proxy, at least when the plaintiff is outside looking in.

(5) Certainly the old talk about implying a private right of action unless the legislation evidences a contrary intention is no longer justified. The lower courts have "got the message":

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123. Borak was cited in Cannon v. University of Chicago, 441 U.S. 677, 711 (1979).

124. Touche Ross & Co. v. Redington, 442 U.S. 560, 577 (1979).

that the burden of the argument now goes the other way.[125] Judge Friendly probably captured the present state of affairs best in his opinion in one of the commodity cases that the Supreme Court recently affirmed, when he said that Cort should be read "in light of the later caveat in Touche Ross & Co. v. Redington, 422 U.S. 560, 575 (1979), that the basic inquiry is always to plumb the intent of Congress, that the Cort factors are simply inquiries helpful in that endeavor, and that satisfaction of one or more of the Cort factors will not alone carry the day."[126]

(6) The 10b-5 and proxy cases aside, the SEC provisions that have most often given rise to implied liability are the tender offer and related provisions under sections 13(d) and 14(e) of the 1934 act, the Federal Reserve margin rules under section 7, various rules of the stock exchanges and the NASD, and section 36(a) of the Investment Company Act. To what extent does the older recognition of actions for damages (as distinct from rescission under the Transamerica case) survive?

2. Tender Offers

In Piper the Court expressly reserved its views on (a) whether either the target or its stockholders had standing

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125. But cf. Wachovia Bank & Trust Co. v. National Student Mktg. Corp., 650 F.2d 342, 352 (D.C. Cir. 1980), cert. denied sub nom. Peat, Marwick, Mitchell & Co. v. Wachovia Bank & Trust Co., 452 U.S. 954.

126. Leist v. Simplot, 638 F.2d 283, 302 n.20 (2d Cir. 1980), aff'd sub nom. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825 (1982).

and (b) whether a tender offeror might obtain injunctive relief distinct from damages.[127] But the Court, despite its disclaimer, almost invites target company or target stockholder actions when it observes that the preliminary injunctive stage is the time when relief can best be given,[128] for somebody must be the plaintiff. And, if the target or its stockholders or both may sue for injunctive relief, why not let them sue for damages as well?

Several circuits--one of them since Piper[129]--have permitted injunctive actions by target companies. The First Circuit, in a pre-Piper case, recognized target actions for damages as well.[130] The Second Circuit, in the first appellate opinion under the tender offer provisions, permitted nontendering stockholders to join the target company as plaintiffs;[131] stockholders who have tendered do not need section 14(e) because they are classic sellers within rule 10b-5. On the other hand, there is authority that target stockholders may not sue their own company for chilling the offer by misrepresenting the offeror's intentions because the very fact that no offer was ever made precludes the required

127. Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 42 n.28, 47 n.33 (1977).

128. 430 U.S. at 42.

129. Marathon Oil Co. v. Mobil Corp., 669 F.2d 378 (6th Cir. 1981).

130. H.K. Porter Co. v. Nicholson File Co., 482 F.2d 421 (1st Cir. 1973).

131. Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969).

proof of reliance on misrepresentations made by target management.[132]

With respect to section 13(d), a sort of pre-tender offer filing requirement, again there is appellate authority--some of it post-Piper--granting injunctive relief to the company and its stockholders.[133] On the other hand, some courts have rejected actions not only for damages[134] but also, since Piper, for injunctive relief.[135] Damage actions for false filings under section 13(d) raise the question whether the exclusive remedy is not under section 18.[136]

3. Federal Reserve Margin Rules

In 1970 the Second Circuit was able to say obiter: "It has long been settled that a person for whom a broker [or presumably

132. Lewis v. McGraw, 619 F.2d 192 (2d Cir. 1980), cert. denied, 449 U.S. 951; Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981), cert. denied, 454 U.S. 1092; but cf. Lowenschuss v. Kane, 520 F.2d 255 (2d Cir. 1975). Panter held also that there was no right of action on behalf of stockholders who had decided not to sell in the market.

133. Chromalloy Am. Corp. v. Sun Chem. Corp., 611 F.2d 240 (8th Cir. 1979) (relief granted without discussion of standing); Dan River, Inc. v. Unitex, Ltd., 624 F.2d 1216 (4th Cir. 1980), cert. denied, 449 U.S. 1101.

134. See Note, Private Rights of Action for Damages under Section 13(d), 32 Stan. L. Rev. 581 (1980).

135. E.g., Leff v. CIP Corp., 540 F. Supp. 857 (S.D. Ohio 1982), citing cases both ways.

136. W.A. Krueger Co. v. Kirkpatrick, Pettis, Smith, Polian, Inc., 466 F. Supp. 800, 802-03 (D. Neb. 1979). On the same question with respect to section 9(e), see Chemetron Corp. v. Business Funds, Inc., 682 F.2d 1149 (5th Cir. 1982), petition for cert. pending. On sections 9(e) and 18, see supra p. 44.

a bank or anybody else] has unlawfully arranged credit has a private right of action," whether in tort or under section 29(b).[137] And the early 1970s produced a number of square appellate holdings.[138] But the more recent holdings are predominantly in the negative,[139] partly under the impact of the recent Supreme Court cases and partly on an in pari delicto approach flowing from the 1970 enactment of section 7(f) of the Securities Exchange Act, which for the first time made it unlawful to borrow in violation of the Federal Reserve rules.

4. Self-Regulatory Organization Rules

The dozen or so appellate cases in this category are based typically on the NASD's suitability rule or the New York Stock Exchange's "know your customer" rule. And, though they are about evenly divided, the more recent holdings, again, are in the negative.[140]

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137. Junger v. Hertz, Neumark & Warner, 426 F.2d 805, 806 (2d Cir. 1970), cert. denied, 400 U.S. 880.

138. E.g., Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970); Goldman v. Bank of the Commonwealth, 467 F.2d 439, 447 (6th Cir. 1972); McCormick v. Esposito, 500 F.2d 620 (5th Cir. 1974).

139. E.g., Utah State Univ. of Agriculture & Applied Science v. Bear, Stearns & Co., 549 F.2d 164, 170 (10th Cir. 1977), cert. denied, 434 U.S. 890; Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 603 F.2d 1073 (4th Cir. 1979).

140. In addition to the collection of circuit court decisions both ways in 2 Federal Securities Code 769-70, see Jablon v. Dean Witter & Co., 614 F.2d 677 (9th Cir. 1980); State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 852-53 (2d Cir. 1981) (NYSE Company Manual section requiring immediate announcement of unusual market activity).

5. Investment Company Act Section 36(a)

Quite apart from restitutional possibilities under the voidability provision in section 47(b) of the Investment Company Act,[141] liability for damages has repeatedly been implied for violation of various provisions of that statute.[142] These holdings extended even to the original section 36, which made nothing unlawful but simply authorized the appropriate district court, at the instance of the commission, to enjoin an investment company officer, director, or adviser (among others) from continuing to act in any of those capacities on a finding of "gross misconduct or gross abuse of trust."[143] The Second Circuit has held that this liability survives both (a) the 1970 addition of section 36(b),[144] which creates an express private right of action for a "breach of fiduciary duty" with respect to compensation,[145] and (b) Transamerica's denial of damages (as distinct from rescission

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141. See, e.g., Esplin v. Hirschi, 402 F.2d 94, 103-04 (10th Cir. 1968), cert. denied, 294 U.S. 928.

142. E.g., Taussig v. Wellington Fund, Inc., 313 F.2d 472, 476 (3d Cir. 1963), cert. denied, 374 U.S. 806; Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), cert. denied, 379 U.S. 961.

143. E.g., Moses v. Burgin, 445 F.2d 369, 373 (1st Cir. 1971), cert. denied sub nom. Johnson v. Moses, 404 U.S. 994.

144. Tannenbaum v. Zeller, 552 F.2d 402, 417 (2d Cir. 1977), cert. denied sub nom. F. Eberstadt & Co. v. Tannenbaum, 434 U.S. 934. The original section 36 became section 36(a), which now refers to "a breach of fiduciary duty involving personal misconduct."

145. See Galfand v. Chestnutt Corp., 545 F.2d 807 (2d Cir. 1976); Grossman v. Johnson, 674 F.2d 115 (1st Cir.), cert. denied sub nom. Grossman v. Fidelity Mun. Bond Fund, Inc., 103 S. Ct. 85 (1982).

under section 47(b)) for violation of the Investment Advisers Act. But questions of individual standing remain.[146]

E. Aspects of Rules 10b-5 and 14a-9

With private actions under rules 10b-5 and 14a-9 assured, we must notice a few questions under those rules that were not discussed in chapter 1 because they are relevant only to private litigation.

1. Reliance and Causation

The Supreme Court held under rule 14a-9 in the Mills case:

> Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.[147]

This holding was followed in the Ute case with respect to rule 10b-5 under "circumstances . . . involving primarily a failure to disclose."[148] This does not mean, however, that causation is irrelevant under either rule. For example:

(1) With respect to rule 14a-9, the Ninth Circuit has held that Mills "is logically limited to situations in which shareholder approval was sought (and fraudulently secured) for a transaction requiring such approval, typically so-called 'fundamental corporate changes.'"[149] By contrast, directors' failure to disclose alleged misconduct (in that case questionable foreign payments) was not "the legal cause of the pecuniary loss to the corporation, if any," so long as there was no underlying transaction that required shareholder approval and the case was not one of self-dealing or fraud against the corporation.[150]

(2) With respect to rule 10b-5 silence cases, the courts have held that lack of reliance is a defense,[151] although the plaintiff may defeat the defendant's rebuttal of the reliance presumption under the so-called fraud-on-the-market theory, which is based on the feeding of false information into the marketplace.[152] Moreover, Ute presumably does not affect considera-

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146. See Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967); SEC v. General Time Corp., 407 F.2d 65, 71 (2d Cir. 1968), cert. denied, 393 U.S. 1026; Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970) (no standing in stockholder of portfolio company).

147. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970).

148. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972) (emphasis supplied).

149. Gaines v. Haughton, 645 F.2d 761, 775 (9th Cir. 1981), cert. denied, 454 U.S. 1145.

150. 645 F.2d at 775; see also Weisberg v. Coastal States Gas Corp., 609 F.2d 650 (2d Cir. 1979), cert. denied, 445 U.S. 951. A number of courts have written in these cases in terms of "a showing of both loss causation--that the misrepresentations or omissions caused the economic harm--and transaction causation--that the violations in question caused the [shareholder] to engage in the transaction in question." Schlick v. Penn-Dixie Cement Corp., 507 F.2d 375, 380 (2d Cir. 1974), cert. denied, 421 U.S. 976. With all the confusion already inherent in the more traditional terms, "causation in fact" or "but for" causation (which is really reliance) and "legal cause" (see 1 Federal Securities Code 57-63), it may be questioned whether adding two new terms advances the discourse. See 507 F.2d at 384 (Frankel, J., concurring).

151. E.g., Rochez Bros. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1973); Vohs v. Dickson, 495 F.2d 607 (5th Cir. 1974).

152. Blackie v. Barrack, 524 F.2d 891, 906 (9th Cir. 1975),

tions of legal causation (as distinct from causation in fact, which is merely reliance); for neither Ute nor its predecessor, Mills, presented questions of "intervening" or multiple causes such as a softening of the market generally.[153]

2. Relief Available

The broad equitable relief that is available to the commission under rule 14a-9 is equally available, presumably, in private actions.[154]

In 10b-5 cases, as stated in the Code's commentary,

> there has been so much variegation in the cases that it is tempting to conclude that "there is no law of damages under Rule 10b-5"--that the courts have taken an ad hoc approach and that, broadly using the common law out-of-pocket measure as an initial reference point, the appellate courts have exercised the discretion traditionally left to the trial courts in finding damages appropriate to the facts of the case.[155]

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cert. denied, 429 U.S. 816; Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981); see Note, The Fraud-on-the-Market Theory, 95 Harv. L. Rev. 1143 (1982) (the "efficient market hypothesis" is the most persuasive rationale for the theory). For a variation of the theory, see Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), cert. denied, 103 S. Ct. 722.

153. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 49 (2d Cir. 1978); see also Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1050 (7th Cir. 1977), cert. denied, 434 U.S. 875; but cf. Gottreich v. San Francisco Inv. Corp., 552 F.2d 866 (9th Cir. 1977).

154. See J.I. Case Co. v. Borak, 377 U.S. 426 (1974), supra text at note 103; Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

155. 2 Federal Securities Code 789, quoting from Note, Measurement of Damages in Private Actions under Rule 10b-5, [1968] Wash. U.L.Q. 165, 179; see John R. Lewis, Inc. v. Newman, 446 F.2d 800, 805 (5th Cir. 1971) ("federal courts may use any available remedy to make good the wrong done"). On the measure of damages in open market transactions, see Fridrich v. Bradford,

3. Buyers' Actions under Rule 10b-5 and Section 17(a)

In late 1983 the Supreme Court saw "no reason to carve out an exception to Section 10(b) for fraud occurring in a registration statement just because the same conduct might also be actionable under Section 11" of the 1933 act.[156] But the Court was able to avoid the question whether a buyer's action might lie under section 17(a) of the 1933 act; nor does this decision answer all the questions created by resort to an implied action of one kind or another when an express action is available.[157]

F. Miscellaneous Aspects of Civil Liability

1. Secondary Liability

There are two bases for secondary liability:

(1) The 1933 and 1934 acts provide, in somewhat different language, that anyone who "controls" a person liable thereunder is equally liable, subject to a special defense that varies in the two statutes.[158] The circuits are split on the question whether the control provisions are exclusive or whether principals are liable for the acts of their agents on common-law

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542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053; Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 172 (2d Cir. 1980); Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94-95 (2d Cir. 1981).

156. Herman & MacLean v. Huddleston, 103 S. Ct. 683, 688 (1983).

157. See L. Loss, Fundamentals of Securities Regulation 1147-52 (1983).

158. Sec. Act § 15; Sec. Ex. Act § 20(a).

agency concepts of respondeat superior without the statutory defenses. The majority view recognizes common-law liability, so that the defenses are available only when the defendant controls as a holding company or in some other nonagency way.[159]

(2) The Code purports to encapsulate the present state of the law with respect to the liability of agents, participants, and aiders and abettors:

> An agent or other person who knowingly causes or gives substantial assistance to conduct by another person (herein a "principal") giving rise to liability under this Code . . . with knowledge that the conduct is unlawful or a breach of duty, or involves a fraudulent or manipulative act, a misrepresentation, or nondisclosure of a material fact by an insider (as defined in section 1603(b) [successor to rule 10b-5]), is liable as a principal. A person may cause or give substantial assistance to conduct by inaction or silence when he has a duty to act or speak.[160]

2. Statutes of Limitations

With regard to the express liabilities, section 13 of the 1933 act provides a double-barreled statute of limitations for all three civil liability provisions in that statute: with respect to section 12(1), one year after the alleged violation of

159. Reyos v. United States, 431 F.2d 1337, 1346-47 (10th Cir. 1970), aff'd on this point and rev'd on other grounds sub nom. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 154 (1972); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 712-17 (2d Cir. 1980), cert. denied sub nom. Wood, Walker & Co. v. Marbury Management, Inc., 449 U.S. 1011; Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980); Henricksen v. Henricksen, 640 F.2d 880, 888 (7th Cir. 1981), cert. denied sub nom. Smith Barney, Harris Upham & Co. v. Henricksen, 454 U.S. 810.

160. § 1724(b)(1); for the cases, see 2 Federal Securities Code 794-96.

section 5 and three years after the security was "bona fide offered to the public"; with respect to section 12(2), "one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence," and three years after the sale; and with respect to section 11, one year after the discovery, as in section 12(2), and three years after the security was offered, as in section 12(1). There are comparable statutes of limitations in the other express liability provisions.

The cases under the 1933 act have consistently followed the general rule in the federal courts that, when the very statute that creates the cause of action also contains a limitation period, the statute of limitations not only bars the remedy but also destroys the liability, so that the plaintiff must plead and prove facts showing that he is within the statute.[161]

So far as the implied liabilities are concerned, there is by hypothesis no statute of limitations; for there is no federal statute of limitations for civil actions generally. In this state of affairs, the Supreme Court has long held that (except with respect to suits for which the sole remedy is in equity) it is federal policy to adopt the local law of limitation. But an action for fraud cannot be barred, regardless of the local statute of limitations, as long as the plaintiff remains in ignorance of the fraud "without any fault or want of diligence or care on

161. Cook v. Avien, Inc., 573 F.2d 685, 695 (1st Cir. 1978).

his part," "though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party."[162] "This equitable doctrine is read into every federal statute of limitations."[163] Moreover, the federal courts are to look to state law only for purposes of finding a period; questions like the characterization of the action for the purpose of selecting the appropriate state limitations provision go to federal law.[164] Similarly, whether or not the particular state statute is tolled by its own terms while a reasonably diligent plaintiff remains in ignorance of any fraud that is an element of the cause of action, the federal courts will apply the tolling doctrine in any event.[165]

This reference to state law has made for a great amount of utterly wasteful litigation. Since there are fifty-two jurisdictions and at least two statutes of limitations to choose from in each jurisdiction and five or six commonly implied actions under the SEC statutes, there are at least five-hundred-odd possible answers. Nevertheless, although quite a few courts have

162. Holmberg v. Armbrecht, 327 U.S. 392, 395 (1946). This includes any local "borrowing" statute. See, e.g., N.Y. CPLR § 202 (applicable when the cause of action accrued outside the state and plaintiff is a nonresident); Industrial Consultants, Inc. v. H.S. Equities, Inc., 646 F.2d 746, 747 (2d Cir. 1981), cert. denied, 454 U.S. 838.

163. Holmberg v. Armbrecht, 327 U.S. 392, 397 (1946).

164. International Union of UAW v. Hoosier Cardinal Corp., 383 U.S. 696, 706 (1966).

165. E.g., Ohio v. Peterson, Lowry, Rall, Barber & Ross, 651 F.2d 687, 691 (10th Cir. 1981).

looked wistfully to what the Fifth Circuit has considered "the logically appealing course of applying the period of limitations applicable to a similar cause of action expressly provided in the federal securities laws,"[166] they are deterred by Judge Learned Hand's caution that it is not "desirable for a lower court to embrace the exhilarating opportunity of anticipating a doctrine which may be in the womb of time, but whose birth is distant."[167]

The Supreme Court has yet to speak in the SEC context.[168] Meanwhile, although the early cases seem to prefer the local limitation periods for fraud actions, the trend has been toward looking to the periods in the blue sky laws. The courts have been much concerned with comparing rule 10b-5 and the local blue sky law in relation to scienter.[169]

166. E.g., McNeal v. Paine, Webber, Jackson & Curtis, Inc., 598 F.2d 888, 892 (5th Cir. 1979).

167. Spector Motor Serv., Inc. v. Walsh, 139 F.2d 809, 823 (2d Cir. 1944) (L. Hand, J., dissenting), quoted by Pollack, J., in Mittendorf v. J.R. Williston & Beane, Inc., 372 F. Supp. 821, 830 n.4 (S.D.N.Y. 1974).

168. Cf. McAllister v. Magnolia Petroleum Co., 357 U.S. 221 (1958) (a court may not apply a shorter period to a judicially created action for unseaworthiness than Congress prescribed for Jones Act negligence); International Union of UAW v. Hoosier Cardinal Corp., 383 U.S. 696, 707 n.9 (1966) ("an unusually short or long limitations period" under state law would raise questions); Occidental Life Ins. Co. v. EEOC, 432 U.S. 355, 367 (1977).

169. Space does not permit more than a reference to other miscellaneous aspects of civil liability: ancillary relief; enforceability of arbitration agreements; in pari delicto, estoppel, and related defenses; indemnification, contribution, and insurance; and attorneys' fees and security for costs.

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L. Loss, Securities Regulation (2d ed. 1961 & Supp. 1969): Volumes 4-6 of this treatise are a 1969 supplement to volumes 1-3, which were published in 1961. In so rapidly moving a field, the treatise is obviously dated; but it is still useful for historical research, and in certain areas it is still reasonably current. Chapters 9-11, respectively, are entitled "'Fraud' Concepts under the SEC Statutes," "The 'Free Market' Concept," and "Civil Liabilities."

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