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NOTES

Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5

Of the vast amounts of statutory and quasi-statutory material governing the securities business, the Securities and Exchange Commission's rule 10b-5¹ has potentially the greatest direct importance to the largest number of people. While several provisions in the government's regulatory scheme set more or less specific standards of conduct for securities issuers, broker-dealers, or corporate insiders, the anti-fraud provisions of rule 10b-5 apply to *all* persons directly or indirectly connected with any sale or purchase of securities transacted through a facility of interstate commerce, the mails, or on a national exchange. In its three clauses, rule 10b-5 forbids any person (1) to employ devices or schemes to defraud, (2) to misrepresent a material fact or to omit a material fact which causes any statement made to be misleading, or (3) to engage in any practice which would operate as a fraud or deceit upon any person. Rule 10b-5 was promulgated by the SEC under the authority of section 10(b) of the Securities Exchange Act of 1934² in order to enable the Commission to protect the market from fraud.³ The rule assumed its broad significance, however, when the courts indicated a willingness to imply⁴

1. 17 C.F.R. § 240.10b-5 (1964). Rule 10b-5 provides:

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

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

"(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

2. 48 Stat. 891, 15 U.S.C. §§ 78j(b) (1958):

"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 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."

3. The SEC Release promulgating rule 10b-5 referred to it as a device to close "a loophole in the protections against fraud administered by the Commission. . . ." SEC Securities Exchange Act Release No. 3230, May 21, 1942.

4. The meaning of the term implied remedy is set out in this language of the Supreme Court: "[D]isregard of the command of the statute [which does not specifically create a civil remedy] is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied. . . ." *Texas & Pac. Ry. v. Rigsby*, 241 U.S. 33, 39 (1916). See generally Note, *Implying Civil Remedies From Federal Regulatory Statutes*, 77 HARV. L. REV. 285 (1963).

a private civil remedy in favor of both buyers and sellers injured by its violation.⁵

When a purchaser of securities brings suit, this judicial initiative in implying a civil remedy poses a logical difficulty. Congress, in section 12(2) of the Securities Act of 1933,⁶ expressly provided the stock purchaser with a cause of action against a seller who had misrepresented a material fact or omitted a material fact making his statements misleading. In other words, section 12(2) specifically affords civil relief for misconduct identical with that treated by clause (2) of rule 10b-5, but section 12(2) is available only to a securities purchaser.⁷ Moreover, Congress placed significant statutory restrictions on the buyer's use of section 12(2), most notably a short, one-year statute of limitations.⁸ Given this detailed enunciation of a buyer's rights by Congress, reluctance by the judiciary to imply another private remedy for buyers under section 10(b) and rule 10b-5, particularly when the alleged fraud is expressly within the ambit of section 12(2), is not surprising.⁹

This hesitation might have developed into intransigence had it not been for the fact that Congress provided no cause of action for *sellers* comparable to that created for purchasers by section 12(2).

5. See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), which is the leading case. See also notes 10, 14 and 51 *infra* and accompanying text.

6. Securities Act of 1933, § 12(2), 48 Stat. 84, as amended, 15 U.S.C. § 771(2) (1958) provides:

"Any person who . . .

"(2) offers or sells a security . . . [except securities issued or guaranteed by the United States or a state or political subdivision], 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." (Emphasis added.)

7. Section 12(2) would, of course, also allow the purchaser recovery on the basis of the practices proscribed by clauses (1) and (3) of rule 10b-5 when they involve misstatements or omissions.

8. Suit must be brought within one year after discovery of the untrue statement or omission and in no event more than three years after the date of sale. Securities Act of 1933, § 13, 48 Stat. 84, as amended, 15 U.S.C. § 77m (1958). There are other restrictions of less general importance: State or municipal securities sales are exempted, the plaintiff is limited to an action for rescission (as opposed to damages) if he still owns the stock at the time of suit, and suit may be brought only against the actual seller or one who is a "controlling person" under § 15 of the Securities Act of 1933, 48 Stat. 84, as amended, 15 U.S.C. 77o (1958).

9. Several cases, decided in the late 1940's, denied buyers the advantages of the implied remedy. See, e.g., *Montague v. Electronic Corp. of America*, 76 F. Supp. 933 (S.D.N.Y. 1948).

Thus, if a buyer's representations misled his seller, the latter could only sue under state law. Courts sought a way to equalize the situation and found the solution by implying civil relief under rule 10b-5 in favor of sellers.¹⁰ Doing so, however, gave the seller an apparent edge over the buyer because a seller's implied remedy was not encumbered by those restrictions surrounding a buyer's section 12(2) action.¹¹ Consequently, courts were faced with the alternative of either confining the buyer's federally created rights to those set out in section 12(2) with its restrictions, which is tantamount to treating a buyer as a second-class fraud victim in comparison with a seller, or else presuming that Congress did not intend section 12(2) to provide the purchaser's exclusive relief under federal law and implying a less restricted remedy under rule 10b-5 in favor of both buyers and sellers.¹²

The recent case of *Trussell v. United Underwriters, Ltd.*¹³ is representative of the growing number of decisions that have elected the latter alternative, permitting a buyer's suit under rule 10b-5, including a suit for alleged misstatements and omissions under clause (2).¹⁴ Plaintiffs were a number of individual purchasers seek-

10. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), is the first case to permit a seller to sue under rule 10b-5.

11. See note 8 *supra*. The controlling statute of limitations on the implied remedy under rule 10b-5 is that limitation period governing common-law suits of similar nature in the state in which the federal district court sits, and the rule 10b-5 suit is usually characterized as fraud. Invariably the state statute of limitations for fraud is longer than the one-year limitation period on a § 12(2) action. See *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 775-76 (D. Colo. 1964); 3 *Loss, SECURITIES REGULATION* 1771-78 (2d ed. 1961).

It should be noted, however, that although § 12(2) contains restrictions that are not present in a suit under rule 10b-5, both § 12(2) and rule 10b-5 suits offer advantages over a common-law fraud action. First, omissions are actionable as long as they are of a material nature. This is not always the case at common law. See generally 42 VA. L. REV. 546-54 (1956). Second, special venue provisions and nationwide service of process are available. Securities Act of 1933, § 22, 48 Stat. 86, as amended, 15 U.S.C. § 77v (1958); Securities Exchange Act of 1934, § 27, 48 Stat. 902, 15 U.S.C. § 78aa (1958).

12. See *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). A third possible alternative, permitting only the seller to sue under rule 10b-5 but reading the restrictions on a buyer's suit under § 12(2) into the seller's rule 10b-5 action, has never been adopted by any court and has been criticized as requiring "too substantial a judicial rewriting of the statutes." 3 *Loss, op. cit. supra* note 11, at 1790.

13. 228 F. Supp. 757 (D. Colo. 1964).

14. The leading case implying a buyer's action is *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951). The *Fischman-Trussell* line of cases has been criticized. See 3 *Loss, op. cit. supra* note 11, at 1778-97. Nevertheless, since *Fischman* no court has seriously challenged the implication of a buyer's remedy from rule 10b-5.

Several courts have also implied a private remedy from § 17(a) of the Securities Act of 1933, 48 Stat. 84, as amended, 15 U.S.C. § 77q(a) (1958). *Dack v. Shanman*, 227 F. Supp. 26 (S.D.N.Y. 1964); *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949). See *Fischman v. Raytheon Mfg. Co.*, *supra* at 787 n.2. Section 17(a) contains language virtually identical to that of rule 10b-5, except that § 17(a) governs only the conduct of sellers. The court in *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964), held that since the express civil remedy of § 12(2) was created by Congress'

ing to recover from the seller-issuers. Some of the plaintiffs sought rescission of the transaction and recovery of their purchase price while others sought damages.¹⁵ Three counts in the complaint charged defendants with various misrepresentations and omissions in violation of rule 10b-5(2). Of these three, two counts failed to allege specifically "fraud," "knowledge of falsity," or "intent to deceive" and were dismissed by the district court as insufficient.¹⁶

Dismissal was necessary, the court ruled, if it were to justify implying a remedy from rule 10b-5 when section 12(2) was already

reworking the wording of § 17(a)(2), it would be going too far to circumvent the restrictions on § 12(2) by implying a remedy directly from § 17(a), apparently because §§ 12(2) and 17(a) were part of the same piece of legislation. *Id.* at 768-69. Those cases which do allow a buyer to sue under § 17(a) would treat it as interchangeable with § 10b-5 and the plaintiff's rights under either as identical. See *Dack v. Shanman, supra*. The discussion in the text, although directed toward rule 10b-5, is, with one exception, note 28 *infra*, applicable also to § 17(a).

15. Plaintiff's Memorandum in Opposition of Motion for More Definite Statements, p. 4, *Trussell v. United Underwriters, Ltd., supra* note 14. There is no indication of the measure of damages sought. Following the majority rule for computing damages in a fraud action, plaintiff would be entitled to the difference between the actual value of the stock and the value which the stock would have had if the defendant's representations had been accurate. PROSSER, TORTS § 105, at 751 (3d ed. 1964). Thus, if plaintiff purchased stock for \$5,000 (its then present market value) on the basis of the defendant's statement that it would double in value within two years when in fact it retained its initial value, plaintiff could recover \$5,000. Under the minority rule plaintiff would receive the difference between the amount he paid and the value of what he received. *Id.* at 750. Applying this measure of damages to the above situation, plaintiff would not be allowed any recovery. But *cf.* note 32 *infra* and accompanying text.

16. The court summarized the two insufficient counts of the complaint:

"The affirmative misrepresentations alleged in paragraph four of the first claim for relief are as follows:

"a. That the stock sold by the defendants to the plaintiffs was worth eight dollars per share.

"b. That the price of the stock would go up in value in the near future.

"c. That the price of the stock would double in two years.

"d. That the price of the stock would go up to twelve dollars per share in six months.

"e. That the sellers would be able to resell in the event the purchaser wanted to trade.

"f. That a market for the stock existed.

"g. That the stock would be listed on a national securities exchange.

"h. That the company was a sure thing.

"i. That no one except one woman had ever asked for their money back, but if a person wanted it back, he could get it back without expense."

"In paragraph four, then, the plaintiffs itemize the affirmative misstatements and half-truths allegedly promulgated by defendants. In paragraph five the plaintiffs shift ground. There they allege neither affirmative misstatement nor intentional concealment; nor do they allege that sort of partial disclosure which would amount to the promulgation of half-truths. They allege, rather, substantially total nondisclosure

"The fourth claim . . . [incorporates the allegations of the first claim but] adds the further allegation that the defendants owed a legal duty to the plaintiffs to disclose full, complete and accurate information, that defendants negligently failed to perform that duty, and that as a proximate result of this alleged breach of duty plaintiffs have been injured. As will later be seen, an allegation of mere negligence does not, in our view, state a claim arising under § 10(b) on which relief can be granted."

Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 760-62 (D. Colo. 1964).

available to provide specific relief for the type of allegations set out in plaintiffs' complaint.¹⁷ The language of section 12(2) allows the defendant-seller to defeat recovery if he proves he neither knew nor reasonably could have known the untruth or incompleteness of his statement.¹⁸ This language incorporates the element of common-law fraud or deceit known as scienter¹⁹ into a section 12(2) action, but as an affirmative defense. Therefore, reasoned the court, the existence of both the section 12(2) express remedy and the rule 10b-5 implied remedy could be reconciled by placing the burden of proving scienter on the plaintiff when the suit is brought under the latter provision. Thus, the two remedies would be distinguishable, and, therefore, in the court's view, compatible without being repetitive because a prima facie action based on section 12(2) is subject to a stringent limitation period but is not circumscribed by the necessity of pleading fraud, while a suit under rule 10b-5 requires the plaintiff to plead and prove scienter as part of his prima facie case.

While the adoption in *Trussell* of an implied remedy for buyers under rule 10b-5 to cover the same misconduct proscribed by section 12(2) seems to be settled law today,²⁰ two defects in the court's analysis are significant. The first lies in the fact that the opinion suggests that there was an underlying theme of congressional intent running throughout the Securities Act of 1933 and the Securities Exchange Act of 1934, as amplified by rule 10b-5, which justifies implying relief from rule 10b-5 and indicates that the plaintiff must plead and prove scienter as part of his case if his cause of action depends upon this implied remedy. The court looked at the implied remedy, with plaintiff bearing the burden on the scienter issue, as fitting into a statutory scheme established by the express private

17. An early case refused relief under rule 10b-5 on the ground that:

"The settled rule of statutory construction is that, where there is a special statutory provision affording a remedy for particular specific cases and where there is also a general provision which is comprehensive enough to include what is embraced in the former, the special provision will prevail over the general provision, and the latter will be held to apply only to such cases as are not within the former."

Montague v. Electronic Corp. of America, 76 F. Supp. 933, 936 (S.D.N.Y. 1948). Cf. *Missouri v. Ross*, 299 U.S. 72, 76 (1936); 2 SUTHERLAND, STATUTORY CONSTRUCTION § 5204 (3d ed. 1943).

18. See note 6 *supra*.

19. The scienter element in a fraud or deceit action has traditionally been defined by the courts as an intent to mislead, derived from the classic dictum in *Derry v. Peek*, [1889] 14 App. Cas. 337. However, much confusion has attended this definition because *Derry v. Peek* fails to suggest what burden of proof the plaintiff must carry and postulates the alternative theories of recovery for a misrepresentation made "(2) without belief in its truth, or (3) recklessly, careless whether it be true or false." *Id.* at 374. Neither of these alternatives requires intent to deceive. The court in *Trussell* seems to adopt a standard similar to the last of these tests. See note 43 *infra*. See generally PROSSER, TORTS § 102, at 715-17 (3d ed. 1964).

20. See note 14 *supra* and accompanying text.

remedies created by the 1933 and 1934 Acts. This is an unsatisfactory rationale. The two acts were adopted primarily to establish standards for securities sellers and to provide for administrative maintenance of these standards.²¹ While each act does allow some private relief,²² it is limited to violations of only a few of the many regulatory provisions created by the legislation. Neither act evidences a design on the part of Congress that a defrauded party to a stock transaction might recover only if scienter could be proved. Furthermore, rule 10b-5 was adopted eight years after the passage of the 1934 Act. Manifestly, the purpose of the rule was to regulate conduct, not to create private remedies for injured buyers or sellers.²³ This regulatory evolution makes it highly improbable that Congress, or the SEC, *intended* an implied private rule 10b-5 suit and even more improbable that they *intended* the implication of a scienter requirement as an element of the implied cause of action.

The second, and more serious, objection to the court's conclusion stems from the fact that it is not clear from the language of rule 10b-5 that scienter should be a necessary part of a plaintiff's case when he seeks relief under this provision. It can easily be argued that the words "defraud," "fraud," and "deceit," used in clauses (1) and (3) of rule 10b-5, carry their common-law connotations and, therefore, include the element of scienter.²⁴ But the language of clause (2), the provision most similar to section 12(2), in no way suggests a requirement of scienter, defined either traditionally (defendant actually knew the falsity of his representations) or in the more modern sense (defendant would or should have known the

21. Cf. note 3 *supra* and note 29 *infra*.

22. The following sections of the 1933 Act are the only ones that afford private relief: § 11 (misstatement in prospectus or registration statement); § 12(1) (offer or sale in violation of the basic prohibitions of § 5 of the act); § 12(2) (misrepresentation or omission of material facts in an offer or sale). Two additional private causes of action were created by the 1934 Act: § 9(e) (manipulation of the market price) and § 18 (misstatement in document filed with SEC). Three of the above provisions are based on negligence, §§ 11, 12(1) and 12(2), while § 9(e) requires proof of willful conduct and § 18 speaks in terms of strict liability. In addition, § 29(b) of the 1934 Act permits rescission on the basis of a proven violation of any provision in the 1934 Act, and § 16(b) allows a corporation (or stockholders suing on its behalf) to recover short-swing profits made by its officers or directors. The most apparent indication that the two acts established no neat scheme is that after their passage the seller still had no practical remedy by which he could recover on the basis of fraud. *But cf.* note 52 *infra*.

23. See note 3 *supra*. The first successful private action maintained under rule 10b-5 was *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). To say that Congress intended a private rule 10b-5 suit as part of a regulatory scheme requiring proof of scienter when the buyer sues is to maintain that Congress, when it enacted the Securities Exchange Act in 1934, foresaw the language of a rule issued eight years later and also realized that the rule would become the basis for private relief twelve years later.

24. *But cf.* cases cited notes 45 and 47 *infra*.

falsity of his representations had he used due care of investigation).²⁵

While the *Trussell* court recognized the interpretative problem in connection with the language of rule 10b-5(2), the court pro-pounded two other reasons, in addition to the need for conforming with a congressional scheme of private relief, to buttress the conclusion that the burden of proving scienter should be re-quired of the plaintiff in a 10b-5 suit irrespective of whether clause (2) literally so dictates. First, the court looked upon rule 10b-5 as chiefly regulatory in purpose and concluded that a private action should be implied only if the plaintiff proved the same type of misconduct the government must show in a criminal prosecution. Therefore, reasoned the court, since some quantum of *mens rea* is normally essential to convict in a criminal case, its civil equivalent, scienter, should be necessary in a private suit.²⁶ The difficulty with this logic is that the objective of rule 10b-5 is to prevent fraudulent sales practices and, without any showing of intent to defraud, the SEC can, under the rule, issue a cease-and-desist order, suspend or revoke a broker-dealer's license, and seek an injunction to protect the public.²⁷ It seems reasonable, therefore, that by analogy a private citizen should be able to prevent injury to himself without showing scienter. Second, the court suggested that since rule 10b-5 was formulated under a statutory enabling provision which permits the SEC to promulgate regulations to curtail any "manipulative or deceptive device or contrivance," the rule would be outside the scope of the Commission's authority if some concept of scienter were not implied.²⁸ This interpretation of the enabling provision is based solely on the court's reaction to the wording. The quoted language may well connote intentional or knowing conduct, but the legislative history of the Securities Exchange Act of 1934, from which it is taken, does not indicate such an implication was in-tended.²⁹

Several cases appear to have taken the language of rule 10b-5 clause (2) at face value and seem to show a willingness to let a buyer sue under this provision without pleading and proving scienter. One

25. See note 43 *infra* and accompanying text. Professor Loss suggests that scienter is not, strictly speaking, necessary to establish a violation of clause (2) but feels it should be implied for purposes of a private suit. 3 Loss, *op. cit. supra* note 11, at 1442 n.45, 1766.

26. *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 772 (D. Colo. 1964).

27. See, e.g., *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); 3 Loss, *op. cit. supra* note 11, at 1442 n.45, 1449 and cases cited.

28. Note 2 *supra*. This ultra vires argument would be inapplicable to § 17a, note 14 *supra*, since § 17(a) was enacted directly by Congress, rather than by authority of an enabling provision.

29. The most meaningful legislative history of the Securities Exchange Act of 1934 is in S. REP. NO. 792, 73d Cong., 2d Sess. (1934); S. Doc. No. 185, 73d Cong., 2d Sess. (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. (1934); H.R. REP. NO. 1838, 73d Cong., 2d Sess. (1934).

opinion indicates that a plaintiff need only prove that a statement upon which he relied was, in fact, false or that an omission was misleading.³⁰ However, the authorities cited to support this proposition discussed requirements for a suit brought under section 12(2) and not under rule 10b-5(2).³¹ Moreover, plaintiff sought to recover his purchase price. This relief is of some significance because in a suit in equity many state courts grant rescission on the basis of any misrepresentation, regardless of whether scienter is shown.³² The clearest example of a decision based on a literal reading of clause (2) is *Dack v. Shanman*.³³ In denying a motion to dismiss the complaint for failure to state a claim in fraud or deceit the court held simply: "It is sufficient to allege that defendant made an untrue statement or omitted to state a material fact." However, this plaintiff also sought only rescission. Dicta in a third case,³⁴ one in which substantial damages were sought, may also support the proposition that proof of scienter is not a requirement of the implied remedy. However, the context suggests the court may have meant only that a showing of scienter in the traditional sense of actual knowledge of falsity (as opposed to a negligent lack of knowledge) is not required.³⁵

Of these two divergent views on the necessity of pleading and proving scienter as an element of plaintiff's prima facie case in a private suit under rule 10b-5(2), that adopted by *Trussell* is the better, but for more compelling reasons than were set out in the opinion. Rule 10b-5(2) must be construed *in pari materia* with three

30. *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds sub nom. Texas Continental Life Ins. Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962).

31. The authorities cited are *Ouachita Indus., Inc. v. Willingham*, 179 F. Supp. 493 (W.D. Ark. 1959); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955). See *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, *supra* note 30, at 23.

32. RESTATEMENT, CONTRACTS § 476, comment *b* (1932). Although some of the plaintiffs in the principal case sought only rescission, even as to them the counts that did not incorporate an allegation of scienter were dismissed. The textual discussion is premised on the belief that no distinction based on the type of relief sought should be made in analyzing the scienter requirement. See note 39 *infra*.

33. 227 F. Supp. 26 (S.D.N.Y. 1964). This case arose under clause (2) of § 17(a) of the Securities Act of 1933. The relationship between § 17(a) and rule 10b-5 is discussed note 14 *supra*.

34. *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).

35. *Id.* at 274. Defendant in this case presented the same argument the *Trussell* court accepted as valid, that the words "manipulative or deceptive device or contrivance" used in § 10(b) of the Securities Exchange Act of 1934 require that the element of scienter be read into rule 10b-5(2) for purposes of a private suit. The *Ellis* court replied, however, that if Congress meant for the SEC to formulate rules directed at fraud only in the *common-law* sense it would probably have said so. See note 19 *supra*; *cf.* note 43 *infra*.

Although other cases can be found which contain references to the scienter problem, the question was not in issue before the court and it is doubtful whether these comments are the products of thoughtful analysis. See, *e.g.*, *Kohler v. Kohler*, 208 F. Supp. 808, 823 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963).

private actions of somewhat similar character expressly created by Congress in the Securities Act of 1933 and the Securities Exchange Act of 1934. Mention has already been made of section 12(2) of the 1933 Act. In addition, section 11 of the 1933 Act³⁶ and section 18 of the 1934 Act³⁷ provide a right of recovery for misrepresentations of a special kind—those appearing in a registration statement (including the prospectus) or in any document filed with the SEC. The characteristic common to these three provisions is that in each the defendant may avoid liability if he can show due care and the reasonableness of his statements.³⁸ Each of these sections establishes a fault-oriented liability. The three provisions together form a pattern with which the implied remedy of rule 10b-5 should be as consistent as possible. Thus, scienter should be an element of the rule 10b-5 cause of action to make it fault-oriented also. This consistency is desirable not because of some logical scheme into which the rule 10b-5 suit must fit, but rather because the judiciary, in implying relief from rule 10b-5, should not render the express but limited relief of sections 11, 12(2), and 18 surplusage.³⁹ This would be the result if proof of scienter were not required in a 10b-5(2) suit since, in most instances, the plaintiff would attempt to ground his action under what would then constitute the strict liability of rule 10b-5. Moreover, there are few situations where relief is available to a plaintiff by the terms of sections 11, 12(2), or 18 where relief could not be as easily obtained under the private action created from rule 10b-5(2).⁴⁰ In addition, of course, any use of rule 10b-5 as a substitute for section 11, 12(2), or 18 permits avoidance of the one-year limitation period governing these provisions.⁴¹

The fact that rule 10b-5 applies to *any* person connected with a securities transaction also has an important bearing on the question

36. 48 Stat. 82, as amended, 15 U.S.C. § 77k (1958).

37. 48 Stat. 897, as amended, 15 U.S.C. § 78r (1958).

38. Under § 11 the defendant may prove that he actually did investigate and still had reasonable grounds to believe the truth of his statement, and under § 18 he may show he acted in "good faith."

39. The standard should be the same whether the plaintiff seeks damages or rescission, even though innocent misrepresentation may suffice in a state common-law rescission case. See generally RESTATEMENT, CONTRACTS § 476, comment *b* (1932). This conclusion is necessary if the implied remedy is not seriously to reduce the value of § 12(2), because this section, although fault-oriented, limits relief to rescission if the complainant still owns the stock. The *Trussell* court adopted a single standard for all plaintiffs regardless of whether they sought damages or rescission. See note 32 *supra*.

40. *Cf. Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955). There are some situations where §§ 11 or 18 might afford a more attractive avenue of recovery than rule 10b-5. For instance, under § 11, a corporation director may be strictly liable for misrepresentations in a prospectus if he merely consents to his name being used in it. A plaintiff may prefer to rely on this provision rather than to attempt to show the defendant-director "made" the statement within the meaning of rule 10b-5(2).

41. Securities Act of 1933, § 13, 48 Stat. 48, as amended, 15 U.S.C. § 77m (1958); Securities Exchange Act of 1934, § 18, 48 Stat. 897, as amended, 15 U.S.C. § 78r (1958).

of whether scienter should be an element of the plaintiff's case in a suit based on this provision. As indicated earlier, the common-law concept of scienter has been expanded by the courts to include more than actual knowledge of falsity.⁴² The term has often come to mean that, considering all the circumstances, and particularly that of accessibility to the facts, the defendant did not act as would the ordinarily prudent person to avoid misrepresentation, either express or by omission.⁴³ Requiring the plaintiff in a rule 10b-5(2) suit to plead and prove scienter in this sense takes cognizance of the fact that one securities seller may have less ability than another to give his buyer an accurate picture regarding a particular purchase, and it apportions liability accordingly. The investor who sells without disclosing some matter of material significance, but which reasonable investigation under his circumstances could not have uncovered, should not be liable. This would not, however, be the result if the language of rule 10b-5(2) were strictly construed so as to preclude the necessity of proof of scienter as a part of the plaintiff's case. On the other hand, the law establishes a higher standard of care for persons closely associated with an issuing corporation and for those who might be termed professionals in the securities business, such as broker-dealers or investment counselors. These persons are viewed as near-fiduciaries in relation to their customers.⁴⁴ Increasingly, the courts are holding that persons in the category of insiders or professionals are under an affirmative duty to investigate a company before they make representations in an attempt to sell its shares.⁴⁵

42. See text accompanying note 25 *supra*.

43. The problem of providing an exact definition of scienter is outside the scope of this note. It is apparent, however, that negligence in the sense in which it is used in the text often suffices. In *United States v. Schaefer*, 299 F.2d 625 (7th Cir. 1962), a *criminal prosecution* under § 17(a) of the 1933 Act, the defendant argued that he had relied in good faith upon the information given him by others when he made certain representations concerning stock to prospective purchasers. The statements were in fact false. The court said: "This ignorance of facts is unavailing as a defense 'where the defendant, by the exercise of due diligence, could have become aware of his mistakes, especially where others may suffer a loss by his misstatements.'" 299 F.2d at 629. See Keeton, *Fraud—The Necessity for an Intent To Deceive*, 5 U.C.L.A.L. Rev. 583 (1958). In light of these developments in the common law of fraud, the court in *Trussell* used overly limiting language when it indicated "reckless disregard" of the truth was the equivalent of scienter. 228 F. Supp. at 772.

44. See, e.g., *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186-92 (1963); *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436-38 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). At times this higher standard of care appears to approximate strict liability. Cf. *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

45. *Berko v. SEC*, 316 F.2d 137 (2d Cir. 1963); *Herring v. Hendison*, 218 F. Supp. 419 (S.D.N.Y. 1963); *SEC v. Chamberlain Associates*, CCH FED. SEC. L. REP. ¶ 91228 (S.D.N.Y. May 16, 1963). An affirmative duty to investigate is imposed by statute upon those responsible for drawing up a registration statement or prospectus. Securities Act of 1933, § 11, 48 Stat. 82, as amended, 15 U.S.C. § 77k (1958). The expanding concept of the professional securities seller's fiduciary duty to his clients as well as to the market as a whole has been the subject of much commentary in recent months.

Because of the imposition of this higher standard, a plaintiff-buyer seeking to recover under rule 10b-5(2) from an insider or professional would find the scienter requirement, as defined above, a bar to recovery only where the defendant acted in the utmost good faith.

Under this analysis, in a case such as *Trussell* where the defendant is an issuer, it would appear that the plaintiff has set out all that is necessary to sustain his rule 10b-5(2) complaint against a motion to dismiss when he has alleged (1) that misstatements or omissions were made and (2) that the one making them was a person bound by this fiduciary obligation and the corresponding duty of investigation. Under the more modern concept of scienter, a plaintiff need not prove actual knowledge of falsity or intent to defraud; he need show only facts evidencing negligence, which will vary according to the circumstances of the particular defendant. In *no* case should a complaint be dismissed as insufficient to state a claim for relief merely because the plaintiff failed to include an incantatory word like "knowingly" or "fraudulently" if negligence is apparent from the facts alleged.⁴⁶ When the defendant is an insider or professional, a complaint which sets out that fact and charges the defendant with untruths or half-truths should be sufficient with nothing more; the duty imposed upon a professional or insider⁴⁷ is such that misrepresentations attributable to a member of one of these classes raises a presumption of a breach of that duty and establishes a prima facie right of recovery. The *Trussell* court was correct in holding that rule 10b-5(2) does not permit recovery without fault, and in concluding that it is the plaintiff's burden to prove the fault. The court failed, however, to take account of either the more liberal

See Cohen & Rabin, *Broker-Dealer Selling Practice Standards—The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691, 702-14 (1964); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1964); Comment, *Current Problems in Securities Regulation*, 62 MICH. L. REV. 680, 730-43 (1964).

46. See notes 19 and 43 *supra*. Cf. *Dioguardi v. Durning*, 139 F.2d 774 (2d Cir. 1944). Concerning the two counts found sufficient, the court stated:

"The second claim incorporates both the substantive allegations made in the first claim [see note 16 *supra*] and the statement that the claim arises under § 10(b) and Rule 10b-5, but adds an allegation that the misleading statements and half-truths promulgated by the defendants were promulgated with full knowledge of their falsity, with full knowledge they would be relied upon by the plaintiffs, and that the plaintiffs did rely thereon to their detriment. The second claim . . . does state a claim arising under Rule 10b-5(2). The fifth claim incorporates both the substantive allegations made in the first claim and the statement that the claim arises under § 10(b) and Rule 10b-5, but adds an allegation that 'the acts of the plaintiffs [*sic*] complained of constituted a device, scheme or artifice to defraud plaintiffs and further operated as a fraud or deceit upon the plaintiffs in connection with purchase of the securities in question.' With the addition of this allegation the fifth claim does state a claim arising under Rule 10b-5(1) and (3)."

Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 762-63 (D. Colo. 1964). The claims found sufficient are set out in note 16 *supra*. Claim three is not material to this discussion.

47. See Heft, *Kahn & Infante, Inc.*, SEC Securities Exchange Act Release No. 7020, Feb. 11, 1963; *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); cases cited note 45 *supra*.

test⁴⁸ of what constitutes fault in a fraud action or of the higher standards of fair-dealing which must be met by those in the defendants' position. Consequently, the court did not recognize the prima facie pleading of fault in the facts alleged in the complaint before it, and in dismissing two counts as insufficient, it misapplied its own rule.⁴⁹

While this discussion has dealt primarily with buyers' suits under clause (2) of rule 10b-5 because it has been in cases of this kind that the question of proof of scienter has been in sharpest focus, if proof of fault, albeit varying in quantity according to the defendant's status, is an element of plaintiff's prima facie case in a rule 10b-5(2) action, it should similarly be an element of claims based upon clauses (1) and (3), which are expressly couched in terms of "fraud" and "deceit."⁵⁰ Likewise, a *seller* should also have the same burden of pleading and proof heretofore suggested for buyers.⁵¹ While it is true that there are no express statutory provisions with which a seller's remedy need be reconciled comparable to those created for buyers by sections 11 and 12(2) of the 1933 Act,⁵² the entire evolution of private recovery under rule 10b-5 was motivated by the courts' desire to establish equality of treatment for both buyers and sellers.⁵³

48. See note 16 *supra*. Cf. note 43 *supra* and accompanying text.

49. The correct *result* was thus probably reached in the three cases discussed earlier in the text, *supra* notes 30, 33 and 34 and accompanying text, because in each case the defendant was apparently a professional in the securities business. They were criticized, however, because the courts seemingly imposed a strict liability on the defendants.

50. See note 1 *supra*.

51. The most frequently cited case involving a seller's suit under rule 10b-5 emphasized the intentional character of defendant's omissions. *Speed v. Transamerica*, 88 F. Supp. 808 (D. Del. 1951). There are apparently no seller's-suit cases holding that scienter is unnecessary for a rule 10b-5 action.

52. Section 18 of the 1934 Act, previously considered in conjunction with §§ 11 and 12(2), text accompanying notes 36-41 *supra*, is available to a seller as well as a buyer. However, § 18 requires proof of reliance by plaintiff and, probably because of the difficulty of this proof, use of § 18 has been negligible. See 3 Loss, *op. cit supra* note 11, at 1753. Therefore, if a seller were allowed to sue under rule 10b-5 without a showing of fault on the part of defendant he would certainly rely on this provision in preference to § 18.

53. See *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961).