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In *Ernst & Ernst v. Hochfelder*,[1] the U. S. Supreme Court held that an action for civil damages cannot be maintained under §10(b) of the Securities and Exchange Act of 1934[2] and Securities and Exchange Commission Rule 10b-5,[3] unless there is an allegation of the defendant's intent to deceive, manipulate or defraud. Thus, some element of scienter is required, and liability cannot be imposed for negligent conduct alone.

The suit arose following exposure of a fraudulent securities scheme perpetrated by Leston B. Nay, president and principal stockholder of First Securities Company of Chicago (First Securities), a member of the Midwest Stock Exchange and of the National Association of Securities Dealers. The petitioner, Ernst & Ernst, an accounting firm, had been retained by First Securities to perform periodic audits of the records of the firm and to prepare for filing with the Securities and Exchange Commission the annual reports required under §17(a) of the 1934 Act.[4] The respondents were customers of First Securities and had been induced by Nay to invest funds in "escrow" accounts represented as yielding a high rate of return. They made payments by personal checks, payable to Nay or to a desig-

1. ___U.S. ___, 96 S.Ct. 1375 (1976).

2. Securities Exchange Act §10(b), 48 Stat. 891 (1934), 15 U.S.C.A. §78j (b) (1970), hereinafter referred to as the 1934 Act. This section makes it "unlawful for any person . . . (b) [t]o use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention or such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

3. 17 C.F.R. §240.10b-5 (1964). This rule, first promulgated in 1942, now provides:

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (1) To employ any device, scheme or artifice to defraud,
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> (2) To make any untrue statement of 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.

4. 15 U.S.C.A. §78q(a) (1970). This section requires that securities dealers preserve such records and accounts as the Commission may prescribe. Commission Rule 17a-5, 17 C.F.R. §240.17a-5, required that First Securities file an annual report of its financial condition, including a statement by the accounting firm about the company's condition and about accounting principles and practices reflected in the annual report. Ernst & Ernst was required to state in its certificate whether the audit was performed in accordance with generally accepted auditing standards.

nated representative,[5] between 1942 and 1966. These payments were not shown on the books and records of First Securities, nor were they reflected in the periodic accounting to the respondents on other investments or in reports from First Securities to the SEC. In reality, the funds invested were converted upon receipt to Nay's personal use.

Nay committed suicide in 1968 and left a note describing the escrow accounts as "spurious" and First Securities as bankrupt. The respondents brought an action for damages in the U. S. District Court under §10(b) of the 1934 Act and Rule 10b-5,[6] and alleged that Ernst & Ernst had "aided and abetted" Nay by its "failure" to conduct thorough audits.[7] The district court rejected Ernst & Ernst's contention that an action for negligent nonfeasance could not be maintained uner §10(b) and Rule 10b-5, but the court found that there was no issue of material fact over whether the audits were properly conducted and therefore entered summary judgment for Ernst & Ernst.[8]

The U. S. Court of Appeals for the Seventh Circuit reversed and remanded.[9] It held that Ernst & Ernst owed a duty of inquiry to the respondents and was liable, since the fraud would have been discovered but for the breach of that duty. The court further found genuine issues of fact over whether Ernst and Ernst's audits were properly conducted.[10] The Supreme Court of the United States granted certiorari[11] to resolve the issue whether a private cause of action lies under §10(b) and Rule 10b-5 when there is no allegation of scienter. The Court held such an allegation to be necessary and reversed the Seventh Circuit.[12]

Federal regulation of the securities market developed as a result of the stock market crash in 1929. The Securities Act of 1933 (1933 Act)[13] provided for full disclosure concerning new stock issues and was designed to protect investors from fraud. The 1934 Act was designed to protect investors from manipulation of stock prices by regulating securities transactions and imposing reporting requirements on companies dealing on national securities exchanges.[14] The creation of the SEC by the 1934 Act indicated the realization of Congress that flexible powers would provide better regu-

5. Nay had instituted procedures under which only he could open mail addressed to him at First Securities or to First Securities to his attention. ___ U.S. at ___, 96 S.Ct. at 1379.

6. Initially, two separate complaints were filed by different groups of respondents. The district court treated the cases as one, and they were consolidated on appeal. The lower court opinion is unreported.

7. The respondents contended that had Ernst & Ernst conducted proper audits, Nay's "mail rule" would have been discovered.

8. ___ U.S. at ___, 96 S.Ct. at 1380.

9. 503 F.2d 1100 (7th Cir. 1974).

10. *Id.* at 1115.

11. 421 U. S. 909 (1975).

12. ___ U.S. at ___, 96 S.Ct. at 1381 (1976).

13. 48 Stat. 74, as amended, 15 U.S.C.A. §77 *et seq.* (1970).

14. ___U.S. at ___, 96 S.Ct. at 1382.

lation than a rigid statutory program.[15] The interaction of both acts provides the SEC with various tools to regulate the sale of securities and affords remedies to injured investors.[16]

Courts have consistently found a private remedy under §10(b) and Rule 10b-5, although neither the rule nor the statute mentions civil liability,[17] and the Supreme Court has upheld this interpretation in several recent cases.[18] But scienter has presented a continuing controversy, and the various circuits have been left to chart their own courses in this murky area.[19]

The problem of scienter was first addressed by the Second Circuit in *Fischman v. Raytheon*.[20] Judge Friendly said that a plaintiff in a private suit under Rule 10b-5 must prove an "ingredient of fraud" for the action to be maintainable.[21] Ten years later, the Ninth Circuit, in *Ellis v. Carter*,[22] reasoned that since there was no congressional restriction of §10(b) to a narrow, common-law-fraud standard, a scienter requirement did not exist.[23]

In *SEC v. Texas Gulf Sulphur*,[24] the Second Circuit took a middle position between its holding in *Fischman* and the Ninth Circuit's decision in *Ellis*. A Texas Gulf Sulphur (TGS) exploration group had discovered substantial mineral deposits, and company insiders purchased TGS stock before disclosure of the discovery had been released to the public. A press release that contained misleading information about the strike was issued. The SEC initiated a civil action under Rule 10b-5 against the insiders who had purchased TGS stock or had disclosed the information to friends and relatives before disclosure to the public. In its decision, the court relied heavily on *SEC v. Capital Gains Research Bureau, Inc.*,[25] where the Supreme Court reversed the district court[26] and the Second Circuit;[27] the

15. *Id.* at ___, 96 S.Ct. at 1382.

16. *See* Note, *Civil Liability under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L. J. 659 (1965).

17. *See* Note, *Negligent Misrepresentations under Rule 10b-5*, 32 CHI. L. REV. 824, n.3 (1965).

18. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

19. "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 non action virtually equivalent to negligence or even liability without fault." 3 L. LOSS, SECURITIES REGULATION, 1432 (2d ed. 1961), and Bucklo, *Scienter and Rule 10b-5*, 76 NW. U. L. REV. 562, 567, n. 26 (1972).

20. 188 F.2d 783 (2d. Cir. 1951).

21. *Id.* at 786-87.

22. 291 F.2d 270 (9th Cir. 1961).

23. *Id.* at 274.

24. 401 F.2d 833 (2d. Cir. 1968) (en banc), *cert. denied*, 394 U. S. 976 (1969).

25. 375 U.S. 180 (1969).

26. 191 F.Supp. 897 (S.D.N.Y. 1961).

27. 306 F.2d 606 (2d. Cir. 1962).

lower courts had held that an intent to injure was necessary for an injunction under Rule 10b-5(3). The Supreme Court stated: "To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute."[28] The Second Circuit in *Texas Gulf Sulphur* thus rejected a scienter requirement and allowed an injunction against the TGS insiders. Judge Waterman, who wrote the opinion, cited *Stevens v. Vowell*,[29] in which the Tenth Circuit stated: "It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact."[30] *Royal Air Properties, Inc. v. Smith*[31] was also cited as a leading case in the trend to eliminate the scienter requirement.[32]

Yet in *Shemtob v. Shearson, Hammill & Co.*,[33] the Second Circuit reaffirmed a need to prove scienter. The court characterized the complaint as "a garden-variety customers' suit against a broker for breach of contract" that, without an allegation of scienter, could not be maintained under Rule 10b-5.[34] The court concluded that allegations of "mere negligence" were insufficient.

The ebb and flow of a requirement of scienter in the Second Circuit[35] illustrates the need for a definitive interpretation of §10(b) and Rule 10b-5 by the Supreme Court. However, none of the Supreme Court cases brought under Rule 10b-5 had dealt with the scienter problem.[36] The Court's decision in *Ernst & Ernst v. Hochfelder* provided a much-needed clarification that will resolve the ambiguity that has existed at the Court of Appeals level.

The Court began its consideration of *Ernst & Ernst v. Hochfelder* with a detailed examination of the legislative history and the purposes of securities-regulation legislation and the subsequent creation of Rule 10b-5. In doing so, the Court said the language of a statute controlled when it was sufficiently clear in its context.[37] The SEC urged, in its amicus curiae

28. 375 U.S. at 200.

29. 343 F.2d 374 (10th Cir. 1965).

30. *Id.* at 379.

31. 312 F.2d 210 (9th Cir. 1962).

32. 401 F.2d at 855. *See* Comment, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1065 (1969).

33. 448 F.2d 442 (2d. Cir. 1971).

34. *Id.* at 445.

35. *See* Bucklo, *supra* note 19, for a detailed discussion of the approaches taken to a scienter requirement by the circuits that have addressed the problem.

36. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Affiliated Ute Citizens v. U. S., 406 U.S. 128 (1972); Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); SEC v. National Securities, 393 U.S. 453 (1969).

37. The Court cited United States v. Oregon, 366 U.S. 643, 648 (1961).

brief, that nothing in the language of §10-b would limit its operation to knowing or intentional practices. The Commission reasoned that since the effect of both negligent and intentional conduct is the same, Congress intended to proscribe all such practices.[38] The Court rejected that approach and found in the terms "manipulative," "device," and "contrivance" evidence that Congress intended to bar only intentional, rather than negligent, conduct.[39]

The respondents argued that since securities regulation was remedial in purpose, it should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes," as the Court had ruled in *Affiliated Ute Citizens v. United States*.[40] The Court rejected that argument, because "Congress fashioned standards of fault in the express civil remedies in the 1933 and 1934 acts on a particularized basis."[41]

In reviewing the legislative history of the 1934 Act, the Court found nothing to indicate that §10(b) was intended to prohibit conduct without scienter. A statement by a spokesman for the drafters indicated that the purpose of §10(b) was to serve as a "catch-all" clause for "new manipulative devices."[42] The Court also reviewed the various reports that were issued and concluded that Congress did not intend to impose liability for practices done in good faith.[43]

In *SEC v. National Securities*,[44] the Court held that the interdependence of the securities laws was to be considered in interpreting the language used. The Commission and the respondents argued that Congress had explicitly required wilful conduct in certain sections of the 1934 Act[45] and concluded that §10(b) should not be read to require more than negligence.

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38. ___ U.S. at ___, 96 S. Ct. at 1383.

39. *Id.* at ___, 96 S. Ct. at 1384. The Court found particularly controlling the use of the term "manipulate." It described it as a term of art when used in connection with securities markets and interpreted use of the term to indicate intentional or wilful conduct designed to deceive or defraud investors.

40. 406 U. S. 128, 151 (1972), *quoting from* SEC v. Capital Gains Research Bureau, 375 U. S. 180, 186 (1961).

41. ___ U. S. at ___, 96 S. Ct. at 1384. The Court noted that the 1933 Act §11(b)(3)(B), 15 U.S.C.A. §77(b)(3)(B) provides for liability of "experts" for misleading statements in portions of registration statements for which they are responsible. However, in other cases good faith is an absolute defense, as is explained in the Securities Exchange Act §18, 48 Stat. 897, as amended 15 U.S.C.A. §78r (1970) which covers misleading statements in any document filed pursuant to the 1934 Act.

42. Thomas G. Corcoran stated: "Subsection (c) [§9(c) of H.R. 7852—later §10(b)] says, 'Thou shalt not devise any other cunning devices.' . . . [S]ubsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices." Hearings on H.R. 7852 and H.R. 8720 before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess., 115 (1934).

43. ___ U.S. at ___, 96 S.Ct. at 1387.

44. 393 U.S. 453 (1969).

45. *See* §9 of the 1934 Act, 15 U.S.C.A. §78i (1970).

The Court found that wherever Congress provided for express civil liability, it "specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake."[46] Also considered significant was the fact that the express civil remedies in the 1933 Act[47] are subject to procedural restrictions not applicable under §10(b) of the 1934 Act. The Court concluded: "We think these procedural limitations indicate that the judicially created private damage remedy under §10(b)—which has no comparable restrictions—cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing."[48] The Court acknowledged that subsection (2) and possibly subsection (3) of Rule 10b-5 could be viewed in isolation as barring any conduct that acted to defraud investors. The Court refused to extend the power granted to the Commission by Congress to cover negligent acts.

In dissent, Justice Blackmun, joined by Justice Brennan, acknowledged the "technical consistency"[49] of the majority but doubted its wisdom. The dissenters quoted *SEC v. Capital Gains Research Bureau*[50] in support of their contention that securities regulations should be construed broadly for the protection of investors. They also relied upon *In re Touche, Niven, Bailey & Smart*,[51] which held that the accountant's duty in certifying statements "is to safeguard the public interest, not that of his client."[52] The dissenters concluded that the decision requires Congress to be more specific in affording the relief for investors that the federal securities laws were thought to provide.

The position enunciated by the majority seems less equitable than the dissenters' approach. The majority acted in an effort to stem the ever-increasing number of complaints brought under Rule 10b-5.[53] In *Shemtob v. Shearson, Hammill & Co.*,[54] the Second Circuit, which more than any other circuit has considered intent and scienter requirements,[55] dismissed a complaint, brought under Rule 10b-5 that alleged mere negligence. That decision illustrates a desire to curb the use of the rule to cover a wider range of practices.[56] The Court correctly concluded that the rule was designed to cover intentional conduct and not conduct that is merely negligent.

Several questions remain unanswered. The Court did not consider whether scienter is necessary in an action for injunctive relief. Nor did the

46. ___ U. S. at ___, 96 S. Ct. at 1388.
47. *See* 15 U.S.C.A. §77a *et seq.* (1970).
48. ___ U. S. at ___, 96 S. Ct. at 1389.
49. *Id.* at ___, 96 S. Ct. at 1391.
50. 375 U. S. 180 (1961).
51. 37 S.E.C. 629 (1957).
52. *Id.* at 670-71.
53. *See* Bucklo, *supra* note 19.
54. 448 F.2d 442 (2d. Cir. 1971).
55. *See* Bucklo, *supra* note 19, at 576.
56. *See* Bucklo, *supra* note 19, at 562.

court address the issue whether reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5.[57] The decision conceivably could shield not only accountants but also attorneys, outside directors and other peripheral figures in a corporation from liability under the securities laws.

It cannot be disputed that the decision will deny defrauded investors an important weapon for recovering their losses. By refusing to expand the rule-making powers of the SEC, the Court has made Congressional action necessary if §10b is to proscribe conduct not involving scienter. If, as the dissenters urge and the majority doubts, it was the intent of Congress to proscribe negligent conduct under §10(b), it remains for Congress to do so.

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57. *See* ___ U. S. at ___, 96 S. Ct. at 1381, n. 12.