

## THE PROSPECTS FOR RULE X-10B-5: AN EMERGING REMEDY FOR DEFRAUDED INVESTORS

THE main theme of federal securities regulation is full disclosure.<sup>1</sup> Both the Securities Act<sup>2</sup> and the Exchange Act<sup>3</sup> attempt to insure the widest possible dissemination of information about corporate affairs. To this end, they impose registration and prospectus requirements for new securities;<sup>4</sup> registration and report requirements for corporations, brokers and dealers;<sup>5</sup> and regulation of exchanges and over-the-counter markets<sup>6</sup>—all under the constant administrative surveillance of the SEC. By such disclosure, Congress hoped to make the quiet accomplishment of fraudulent schemes an arduous and risky endeavor.<sup>7</sup> For the most serious abuses in securities transactions stem from misrepresentation or concealment of facts which the

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1. All states except Nevada also have securities acts. For a collection of these statutes, see 1 & 2 CCH BLUE SKY REP. These state "blue sky" laws fall generally into three categories: (1) pure fraud acts, in the sense that a state official has authority merely to investigate and bring injunctive and criminal actions where fraud occurs in the purchase or sale of securities within the state, but prior registration and/or approval of securities (*i.e.*, "qualification") or of dealers is not required; (2) fraud provisions together with broker-dealer registration; and (3) securities registration acts, which are almost universally accompanied by both fraud and broker-dealer registration provisions. See generally, Wright, *Correlation of State Blue Sky Laws and the Federal Securities Acts*, 26 CORNELL L.Q. 258 (1941); Smith, *The Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP. PROB. 241 (1937); Smith, *State "Blue-Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135 (1936).

For a discussion of foreign experience with securities legislation, see Kessler, *The American Securities Act and its Foreign Counterparts: A Comparative Study*, 44 YALE L.J. 1133 (1935); May, *Financial Regulation Abroad: The Contrasts with American Technique*, 47 J. POL. ECON. 457 (1939); Neff, *A Civil Law Answer to the Problem of Securities Regulation*, 28 VA. L. REV. 1025 (1942). See also Gargas, *The New Company Law of Holland*, 13 J. COMP. LEG. (3d ser.) 72 (1931); Koch & Auerbach, *The German Company Law of 1931*, 18 VA. L. REV. 850 (1932); Melin, *The New Swedish Companies Act*, 83 J. ACCOUNTANCY 48 (1947); Palmer, *Securities Legislation in Canada*, 20 J. COMP. LEG. (3d ser.) 230 (1938); Comment, *British Corporate Law Reform*, 56 YALE L.J. 1383 (1947).

2. 48 STAT. 74 (1933), as amended, 15 U.S.C. § 77a *et seq.* (1946) (cited hereafter in text and footnotes by section number only).

3. 48 STAT. 881 (1934), as amended, 15 U.S.C. § 78 *et seq.* (1946) (cited hereafter in text and footnotes by section number only). For an invaluable guide to both the Securities Act and the Exchange Act, relied on heavily in the preparation of this Comment, see LOSS, CASES AND MATERIALS ON SEC ASPECTS OF CORPORATE FINANCE (1947) (mimeograph). See also McCORMICK (at present an SEC Commissioner), UNDERSTANDING THE SECURITIES ACT AND THE SEC (1948); CHERRINGTON, THE INVESTOR AND THE SECURITIES ACT (1942).

4. *E.g.*, Securities Act §§ 5-10.

5. Exchange Act §§ 12, 13, 15, 17(b).

6. Exchange Act §§ 6-9, 15, 17.

7. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 2-7, 13 and *passim* (1934); SEN. REP. NO. 792, 73d Cong., 2d Sess. 9 (1934).

professional promoter, the corporate insider, and the trained dealer know as a matter of course.<sup>8</sup>

Hand-in-hand with these preventive measures, Congress provided specific causes of action by which defrauded investors could recover damages when violations of the Acts occurred.<sup>9</sup> These actions, however, were carefully circumscribed by short statutes of limitations and by a variety of defenses.<sup>10</sup> Moreover, the express remedies were by no means exhaustive. They did not cover all abuses, and for the most part they were buyers' remedies only. Thus, an investor tricked by a corporate insider into selling his securities for a fraction of their worth had no express remedy at all.<sup>11</sup>

In 1942, however, the SEC promulgated a new rule under a general anti-fraud provision of the Exchange Act—Section 10(b).<sup>12</sup> This rule, X-10B-5, in blanket terms made it unlawful for any person in connection with the purchase or sale of any security

- “(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  
 . . . .”<sup>13</sup>

8. See, e.g., SEN. REP. No. 1455, 73d Cong., 2d Sess. 55 (1934); *Hearings before Sen. Committee on Banking and Currency on S. Res. 84, S. Res. 56 and S. Res. 97*, 72d Cong., 1st and 2d Sess.; 73d Cong., 1st and 2d Sess. 531-48 and *passim* (1932-4).

9. Securities Act §§ 11, 12(1), and 12(2); Exchange Act §§ 9(e) and 18(a). Prior to enactment of these provisions there was no way for the government to proceed against securities frauds except through prosecutions under the mail fraud statute, 18 U.S.C. § 1341 (1949), or for conspiracy to violate the mail fraud statute, 18 U.S.C. § 371 (1949). In addition, the Postmaster-General is authorized to revoke the privilege of using the mails by an *ex parte* administrative proceeding when he finds that the mails have been used to defraud. None of the safeguards of the Administrative Procedure Act, 60 STAT. 237, 5 U.S.C. § 1001 (1946), apply to such proceedings. *Bersoff v. Donaldson*, 174 F.2d 494 (D.C. Cir. 1949); see Note, 62 HARV. L. REV. 1060 (1949).

10. For a discussion of these defenses and statutes of limitation, see pages 1126-7 *infra*.

11. The Exchange Act does provide two express remedies available to both buyers and sellers, Sections 9(e) and 18(a), but they cover only certain designated and narrow kinds of activity. See discussion pages 1128-9 *infra*. Sellers had no express remedy for misrepresentation or non-disclosure to them by buyers.

12. “Sec. 10. 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 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.” 48 STAT. 881, 891 (1934), 15 U.S.C. § 78j (1946).

13. Exchange Act Release No. 3230 (May 21, 1942); 17 CODE FED. REGS. § 240.10b-5

Defrauded sellers, casting about for a remedy which the Acts did not specifically supply, found their answer in Rule X-10B-5. Since the SEC is empowered to enforce all sections of the Exchange Act,<sup>14</sup> there was no doubt that the Commission could either institute investigatory proceedings or bring administrative or injunction actions against violators of the rule.<sup>15</sup> And even though Section 10(b) makes no express provision for a private action, courts, starting with the *Kardon* case in 1946,<sup>16</sup> have consistently implied one.<sup>17</sup> Moreover, in sustaining these actions, they have announced that Rule X-10B-5 imposes standards of disclosure higher than those of the common law.<sup>18</sup>

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(1949). The rule is virtually a replica of Securities Act § 17(a), which applies only to fraud and misrepresentation in the sale of securities, rather than in connection with the purchase and sale of securities.

The SEC had long been aware of the gap in protection of sellers. During the course of hearings on a general amendment program in 1941-2, the Commission and various industry representatives proposed that Securities Act § 17(a) be amended to include fraud and misrepresentation in the purchase as well as sale of securities. See *Hearings before House Committee on Interstate and Foreign Commerce on a Comparative Print Showing Proposed Changes in the Securities Act of 1933 and the Securities Exchange Act of 1934, etc.*, 77th Cong., 1st Sess. 856-7 (1941); REPORT ON THE CONFERENCES WITH THE SECURITIES AND EXCHANGE COMMISSION AND ITS STAFF ON PROPOSALS FOR AMENDING THE SECURITIES ACT OF 1933 AND THE EXCHANGE ACT OF 1934 (Joint Report of Investment Bankers Association of America, National Association of Securities Dealers, Inc.; N.Y. Curb Exchange and N.Y. Stock Exchange) 164-67 (1941). Further consideration of the program ended with the war. Thus foreclosed, the Commission adopted an expedient which had been available to it from the beginning, but apparently overlooked.

14. Exchange Act § 21.

15. Criminal proceedings may be instituted by the U.S. Attorney-General. Exchange Act § 21(e). Thus far, there have been six criminal convictions under Rule X-10B-5, all on pleas of guilty or *nolo contendere*. In addition there are two criminal cases now pending. 13 SEC ANN. REP. 116 (1947); 15 *id.* 169 (1949). The SEC, however, has relied primarily on its own administrative and civil proceedings. Of the first ten civil complaints filed involving security purchases, eight were terminated by consent decrees and two were dismissed by stipulation. Note, *SEC Action Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV. 769, 771 n.9 (1946). Another proceeding by the Commission never reached the complaint stage, as the purchasers agreed to make restitution. *In re Ward La France*, 13 S.E.C. 373 (1943).

16. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (on motion to dismiss complaint), 73 F. Supp. 798 (E.D. Pa. 1947) (on the merits), 83 F. Supp. 613 (E.D. Pa. 1947), 46 MICH. L. REV. 680 (1948) (on request for additional findings).

17. *E.g.*, *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947); *Grand National Lodge of International Association of Machinists v. Highfield*, Civ. No. 3661-48, D.D.C., Jan. 24, 1949; *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949).

18. *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). Compare *Geller v. Transamerica Corp.*, 53 F. Supp. 625 (D. Del. 1943) (common law action dismissed), with *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947) (common law count dismissed, Rule X-10B-5 count sustained). *Cf.* *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437-8 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). For a possibly contrary view, see *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949), vigorously criticized by Chief Judge Biggs in dissent. *Id.* at 815. See note 107 *infra*.

These developments, however, have raised more questions than they have answered. Section 10(b) gives a right of action to buyers as well as sellers. Moreover, its terms are so inclusive that violations of the specific liability provisions of the two acts are violations of Section 10(b) too. How then does Section 10(b) mesh with the express remedies? Do the limitations imposed on the other remedies carry over to an action under Section 10(b) or can a buyer, for example, use Section 10(b) to finesse them?

Rule X-10B-5 also raises distressing questions as to substance. If it imposes higher standards than does the common law, how much higher? Is every person under a duty to make full disclosure, or does the scope of the duty vary among insiders, brokers and dealers, and the ordinary investor who is playing a hot tip? And what is full disclosure?

In short, is Rule X-10B-5 a boon, a bust, or something in between?

#### COMPETING AVENUES FOR CIVIL RELIEF

##### *The Common Law*

One reason for putting specific civil liability sections in the Securities Acts was the notorious inadequacy of common law remedies in regard to both misrepresentation and non-disclosure.<sup>19</sup> On paper, the victim of misrepresentation had a promising avenue of recovery. In an equity suit for rescission, he would prevail merely by showing misrepresentation of a "material fact" on which he had "relied," even though the defendant had been innocently unaware of the misstatement.<sup>20</sup> But there was less in this remedy than met the eye. Plaintiff buyer could use it only if he still had the securities and could "tender back" to the defendant.<sup>21</sup> His right to rescind would also be cut off by any action, such as receipt of dividends, which might be construed as a "waiver."<sup>22</sup> Any delay on his part raised the defense of

19. See Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 231-42 (1933).

"In the ideal of the law . . . [there were] very great risks of liability. . . . [But] reality was not so harsh. Reality was sporting: very few investors brought suit. Reality was indulgent: the men empowered to decide cases made many allowances for the practices of the times. . . ." *Id.* at 242.

On the common law remedies for misrepresentation and non-disclosure generally, see PROSSER, TORTS §§ 85-90 (1941). For a collection of articles dealing with these torts, see PROSSER, *supra*, at 727 n.50.

20. PROSSER, TORTS 708 (1941). See *Seneca Wire & Mfg. Co. v. A. B. Leach & Co.*, 247 N.Y. 1, 159 N.E. 700 (1928) (action at law for restitution treated the same as equity suit for rescission; *People v. Federated Radio Corp.*, 244 N.Y. 33, 40-1, 154 N.E. 655, 657-8 (1926) (N.Y. GEN. BUS. LAW Art. 23-A (Martin Act), proscription of fraud interpreted as "equitable" fraud; unnecessary that scienter be proved); and see cases and discussion in Shulman, *supra* note 19, at 231 n.11.

21. *E.g.*, *Sedden v. Northeastern Salt Co.* [1905], 1 Ch. 326. Exceptions have been made where the securities were worthless. *Continental Jewelry Co. v. Pugh Bros.*, 168 Ala. 295, 53 So. 324 (1910). See PROSSER, TORTS 709 (1941).

22. *E.g.*, *Brennan v. National Equitable Investment Co.*, 247 N.Y. 486, 160 N.E. 924 (1928).

"laches."<sup>23</sup> Moreover, he could sue only the immediate party to the transaction.<sup>24</sup> Often, as in the case of a distribution of new securities, the immediate seller was not the one who made the misrepresentation. Finally, it was difficult to prove to unsympathetic courts that a statement was "fact" and not "opinion," and if fact that it was "material" rather than "immaterial."<sup>25</sup>

The only other action available for misrepresentation was a tort action for deceit.<sup>26</sup> Here again "privity" was a stumbling block to many actions.<sup>27</sup> Moreover, plaintiff not only had to establish that he had relied on defendant's misrepresentation of a material fact.<sup>28</sup> He also had two additional burdens to sustain: that the misrepresentation in fact caused his damage,<sup>29</sup> and that the defendant either knew he was making a misstatement or was reckless in making it.<sup>30</sup> Causation in particular was extremely difficult if not impossible to prove. For the fluctuations in market value which give rise to the plaintiff's damages are the result of a host of causes. In brief, therefore, common law "remedies" made "an arsenal of defensive doctrines available to defendants and courts."<sup>31</sup>

23. *E.g.*, *Maginess v. Western Securities Corp.*, 38 Cal. App. 56, 175 Pac. 277 (1918).

24. See 3 WILLISTON, SALES §§ 636a, 636b (rev. ed. 1948).

25. See discussion and cases cited in Shulman, *supra* note 19, at 233, 236-8; PROSSER, TORTS §§ 88, 89 (1941).

26. Apparently, an action for breach of warranty is as good as non-existent in securities transactions, for UNIFORM SALES ACT § 12 expressly declares, "No affirmation of the value of goods, nor any statement purporting to be a statement of seller's opinion only, shall be construed as a warranty." See, *e.g.*, *Henderson v. Plymouth Oil Co.*, 13 F.2d 932 (W.D. Pa. 1926); Williston, *Representation and Warranty in Sales—Heilbut v. Buckleton*, 27 HARV. L. REV. 1 (1913). This attitude is perpetuated in UNIFORM COMMERCIAL CODE, SALES § 2-102(1) (ALI PFD 1949) which defines goods specifically to exclude stocks. The comment thereto says, p. 41: "Shares of stock are expressly excluded from the coverage of this article. . . ."

27. Privity was framed in terms of duty—whether the defendant had any duty to the particular plaintiff involved. Thus the issuer of a prospectus containing misrepresentations was not responsible to the ultimate investor who purchased from a distributor of the new issue. *Cheney v. Dickinson*, 172 Fed. 109 (7th Cir. 1909); *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931).

28. *E.g.*, *Parnes v. Gnome Mfg. Co.*, 93 N.J. Eq. 470, 117 Atl. 148 (Ct. Err. & App. 1922); see PROSSER, TORTS § 88 (1941).

29. See cases collected in PROSSER, TORTS 769 n.29 (1941).

30. Typically, plaintiff in a deceit action had to establish "scienter"—that defendant knew his representations to be false. *E.g.*, *Derry v. Peek*, 14 App. Cas. 337 (1889) (the leading English case); *Reno v. Bull*, 226 N.Y. 546, 124 N.E. 144 (1919). But some courts have watered down the definition of scienter from knowledge to "recklessness" or "lack of reasonable grounds for belief." They have thus done in effect what other courts have done directly—created a remedy for negligent misrepresentation. See PROSSER, TORTS 734-5; Bohlen, *Should Negligent Misrepresentations Be Treated as Negligence or Fraud?*, 18 VA. L. REV. 703 (1932); Green, *Deceit*, 16 VA. L. REV. 749 (1930). There is no indication, however, that substitution of negligence for scienter provided a miraculous cure, or anything like it, for defrauded investors. Other high hurdles still remained.

31. Shulman, *supra* note 19, at 238.

Yet weak as the remedies for misrepresentation had been, the remedies for non-disclosure were even weaker.<sup>32</sup> Plaintiff had no right to disclosure unless defendant had a duty to disclose and few people were held to have this duty.<sup>33</sup> A majority of courts at least paid lip service to the rule that even corporate officers and directors need not disclose secret information in private transactions with holders of their corporation's stock, on the rather preposterous theory that these insiders had a "fiduciary duty" to the corporation but not to the corporation's stockholders.<sup>34</sup> Other courts have refused to countenance this theory,<sup>35</sup> and many of the "majority" have waived their rule when particularly crucial facts were concealed.<sup>25</sup> Never-

32. In theory, at least, there was a distinction between misrepresentation and non-disclosure. While misstatements laid the basis for rescission or a tort action for deceit, mere silence or passive non-disclosure generally would not. *Peek v. Gurney*, L.R. 6 H.L. 377 (1873). The distinction was somewhat blurred when misrepresentation was broadened to include implied misstatements. In other words, if a party talks at all, he cannot omit facts necessary to prevent his statements from being misleading. *Rex v. Kysant*, 23 Cr. App. R. 83 (1931), 45 HARV. L. REV. 1078 (1932). A defendant is under a duty not only to "state truthfully what he actually tells, but also not to suppress any fact within his knowledge which will materially change or alter the effects of the facts stated." *Equitable Life Ins. Co. of Iowa v. Halsey, Stuart & Co.*, 312 U.S. 410, 425 (1940); see also 3 RESTATEMENT, TORTS § 529 (1938); PROSSER, TORTS 722 (1941). And practically speaking, it seems that an investor is no less defrauded when he buys or sells in ignorance of the real facts than when he does so on the strength of misrepresentation. But the common law has preserved a distinction—everyone is under a duty not to make express or implied misrepresentations in statements actually made, but few have a duty to speak. 3 RESTATEMENT, TORTS § 551 (1938).

33. "(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated

(a) such matter as the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them. . . ." 3 RESTATEMENT, TORTS § 551 (1938); see also PROSSER, TORTS 723-4 (1941).

34. *E.g.*, *Carpenter v. Danforth*, 52 Barb. 581 (Sup. Ct. N.Y. 1868); *Connolly v. Shannon*, 105 N.J. Eq. 155, 147 Atl. 234 (Ch. 1929). See Note, 84 A.L.R. 615 (1933); 3 FLETCHER, CYCLOPEDIA OF CORPORATIONS §§ 1168-72 (rev. ed. 1947); BALLANTINE, CORPORATIONS 211-12 (rev. ed. 1946).

35. *E.g.*, *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903). See Note, 84 A.L.R. 615, 622-3; 3 FLETCHER, *op. cit. supra* note 34, at 783. Most commentators support this view. See, *e.g.*, *Berle, Publicity of Accounts and Directors' Purchases of Stock*, 25 MICH. L. REV. 827, 831 (1927). But see *Walker, The Duty of Disclosure by a Director Purchasing Stock From His Stockholders*, 32 YALE L.J. 637 (1923).

36. *E.g.*, *Strong v. Repide*, 213 U.S. 419 (1909); *Buckley v. Buckley*, 230 Mich. 504, 202 N.W. 955 (1925); *cf. Fischer v. Guaranty Trust Co.*, 259 App. Div. 176, 18 N.Y.S.2d 328 (2d Dep't 1940); Note, 84 A.L.R. 615, 622-33 (1933); 3 FLETCHER, *op. cit. supra* note 34, at 786-90.

"Such special circumstances or developments have been held to include peculiar knowledge of directors as to important transactions, prospective mergers, probable sales of the entire assets or business, agreements with third parties to buy large blocks of stock at a high price and impending declarations of unusual dividends. . . ." BALLANTINE, CORPORATIONS 213 (rev. ed. 1946). In effect, therefore, the special circumstances doctrine is usually equivalent to the minority rule imposing a "fiduciary duty."

theless, it was the rare plaintiff who found it financially feasible to assemble his proof and bring an action.

### *Federal Statutory Remedies*

*Securities Act of 1933.* The Securities Act super-imposed on this body of common law three specific sections which provide civil remedies for violations of the Act's statutory prohibitions.<sup>37</sup> Under any of these sections, an injured buyer can recover whatever he lost from the depreciation of his securities. Section 11 permits him to sue almost anyone who had anything to do with a new issue if the prospectus accompanying it contained a misstatement or material omission.<sup>38</sup> Section 12(1) permits him to sue his seller if the seller failed to give him a prospectus or if the issuer failed to register the security. And Section 12(2) creates a cause of action against a seller who has misrepresented material facts in the sale of any security, registered or exempt, other than a government or bank issue.<sup>39</sup> Finally, Section 17(a), though it does not specifically create a private right of action, makes it unlawful for any person in the sale of any security to perpetrate any fraud or material misrepresentation.

These provisions—like common law remedies—are not so helpful as they seem at first glance.<sup>40</sup> Congress thought it desirable to narrow the circumstances under which plaintiffs could recover. Thus, a plaintiff suing

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37. Securities Act §§ 11, 12(1) and 12(2).

38. The list of potential defendants includes every person who signed the registration statement; every person who was a director or partner in the issuer when the statement was filed; every person who, with his consent, is named in the registration statement as being, or about to become, a director or partner; every underwriter, or accountant, engineer or appraiser who with his consent is named as having prepared or certified any part of the registration statement or any report in connection with it. Securities Act § 11. Any person, who through stock ownership, agency or otherwise controls a person liable under § 11 is also made liable to the same extent. Securities Act § 15.

39. Government and bank securities are also exempt from the prospectus and registration requirements. Securities Act § 3(a)(2). Bank issues must be those of a national bank or a bank supervised by a state banking commissioner. Apparently the theory behind these exemptions is that opportunities for abuse are negligible.

40. In 17 years, there have been only twenty-seven reported cases under §§ 11, 12(1) and 12(2): eleven under § 11; two under § 12(1); and fourteen under § 12(2). Only sixteen went to final judgment; of these, plaintiffs won in only four cases.

There are a variety of possible reasons for this extreme paucity of cases. First, because of close SEC supervision, few registration statements of prospectuses contain material misstatements or omissions giving rise to a § 11 action. Second, other preventive measures in the Securities Act and Exchange Act, see page 1120 *supra*, have been quite successful in reducing fraud. Third, it may be that many potential § 12(1) and § 12(2) complaints are settled out of court. Fourth, many potential plaintiffs never know that they have been hurt by actionable behavior on the part of issuers or sellers. Fifth, many transactions involve such relatively small amounts that legal action is not worth the expense. Sixth, the actions contain many of the hurdles similar to those at common law (see text discussion immediately following). And see Comment, *Civil Liability under the Federal Securities Act*, 50 YALE L.J. 90 (1940).

under any of these sections is faced with a short statute of limitations, in no case exceeding three years. An action under Section 12(2), for example, must be brought within one year after discovery of the misrepresentation and within three years of the sale.<sup>41</sup> A buyer bringing an action under 12(1) or 12(2) is limited by a "privity" requirement.<sup>42</sup> He can sue only the seller or the agent of the seller, or a party who "controlled" the seller.<sup>43</sup> Plaintiffs suing under Section 11 may be forced to put up security for costs in the event they lose.<sup>44</sup>

Moreover, both 11 and 12(2) provide a defendant with one or more affirmative defenses. In any action under 12(2), defendant will win if he can show that he did not know and in the exercise of "reasonable care" could not have known that he was making a misrepresentation. In an action under Section 11, all defendants will prevail by showing that plaintiff knew of the untruth or omission, and most will win by demonstrating that they had made a reasonable investigation of the facts or had reasonable grounds for belief.<sup>45</sup> Finally, under 12(2), plaintiff has the additional burden of proving that he didn't know that the misstatement was in fact a misstatement.<sup>46</sup>

Furthermore, the Securities Act deals primarily with the distribution of new securities rather than with trading.<sup>47</sup> Hence the Act is more solicitous of the defrauded buyer than the misled seller. None of the specific civil liability sections is available to sellers. Only Section 17(a)—which outlaws fraud "in the sale of" securities, without expressly providing for a private

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41. Actions under Securities Act § 11 must be brought within one year after discovery and within three years after the security was "bona fide offered to the public"; actions under Securities Act § 12(1) must be brought within one year after the violation occurred and within three years after the security was first offered to the public. Securities Act § 13.

42. Shulman, *supra* note 19, at 243: "The liability [under § 12(2)] is imposed in favor of the immediate vendee only." Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 177 (1933): "Section 12, however, limits suits to those by buyers against their immediate sellers." See *Cady v. Murphy*, 113 F.2d 988 (1st Cir. 1940), affirming *Murphy v. Cady*, 30 F. Supp. 466 (D. Me. 1939), *cert. denied*, 311 U.S. 705 (1940).

43. Securities Act § 15. These "controlling persons" may, however, escape liability if they can prove a lack of "knowledge . . . or reasonable grounds to believe in the existence of the facts by which the liability of the controlled person is alleged to exist." *Ibid.*

44. Securities Act § 11(e) goes even further. It authorizes a court, in its discretion, to require security for costs "under this or any other section of this title." Although apparently never invoked, this section would authorize a requirement of security for costs under Securities Act §§ 12(1) and 12(2) as well.

45. Only the issuer lacks a "due care" defense. Securities Act § 11(b).

46. This is similar to the "reliance" requirement in common law actions. PROSSER, *TORTS* § 88 (1941).

47. Securities Act § 12(2), however, deals with trading, as does Securities Act § 17(a).

action—might have been interpreted to include fraud on either side of the bargain. But it was not.<sup>48</sup>

*Exchange Act of 1934.* The Exchange Act of 1934 gave the seller only a little more. It gave him, together with the buyer, specific remedies for two specialized types of unfair conduct. Section 9(e) permits a buyer or seller to sue any person who has wilfully engaged in manipulative activities with respect to any security registered on an exchange.<sup>49</sup> Section 18(a) gives buyers and sellers a cause of action against those who have made false and misleading statements in any application, report or document filed under the Act.<sup>50</sup>

In addition, Section 16(b) permits any security holder to recover for the corporation (if it has a registered equity security) any profits earned by an insider from the purchase and sale of any equity security within a six-months period.<sup>51</sup> In order to pursue the remedy under Section 16(b) the security holder need not be the buyer or seller in the suspect transaction.

48. See note 13 *supra*.

49. The line between lawful stabilization and unlawful manipulation is a shadowy one. The general anti-manipulation provisions in Exchange Act § 9(a)(2), for which Exchange Act § 9(e) provides a remedy, are limited by § 9(a)(b), which outlaws stabilization only if effected in contravention of Commission rules. Aside from certain disclosure rules, the SEC has only one rule which substantially distinguishes between the two—Rule X-9A6-1, 17 CODE FED. REGS. § 240.9a6-1 (1949)—which is limited to offerings made “at the market” instead of at a fixed price. The Commission is now inviting comment on a proposal to draft a new rule defining legitimate stabilization. Exchange Act Release No. 4163, Sept. 16, 1948. The only judicial effort to distinguish between stabilization and other forms of manipulation is *Stella v. Kaiser*, 82 F. Supp. 301 (S.D. N.Y. 1948). On the general problem, see Parlin & Everett, *Stabilization of Securities Prices*, 49 COL. L. REV. 607 (1949); Comments, 56 YALE L.J. 333 (1946); 56 YALE L.J. 509 (1946).

50. “The Act, being primarily for the protection of investors, imposes civil liability . . . upon any person who knowingly makes false and misleading statements in an application for the registration of a security for sale on a national exchange. The purpose is to require complete and truthful exposure of all matters in relation to the registrant's financial condition. . . .” *Bank of America Nat. Trust & Savings Assoc. v. Douglas*, 105 F.2d 100 (D.C. Cir. 1939).

51. Actions by stockholders under Exchange Act § 16(b) are in the nature of stockholder derivative suits. See *Pottish v. Divak*, 71 F. Supp. 737 (S.D.N.Y. 1947). Litigation under this section has been comparatively slight. The reported opinions include *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir. 1943), 12 FORD. L. REV. 282 (establishing constitutionality of § 16(b)); *Park & Tilford Inc. v. Schulte*, 160 F.2d 984 (2d Cir. 1947), *cert. denied*, 332 U.S. 761 (1947) (establishing a rigorous measure of recapturable profits); *Pottish v. Divak*, *supra*; *Grossman v. Young*, 72 F. Supp. 375 (S.D.N.Y. 1947) (broadly defining statute of limitations to prevent action from being barred); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir. 1949), *cert. denied*, 337 U.S. 907 (1949), 35 CORNELL L.Q. 236 (holding, *inter alia*, that receipt of stock rights was not a “purchase” under § 16(b)); *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), 62 HARV. L. REV. 706 (1949) (holding charitable gifts did not constitute “sales” under the Act). See also *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949), *reversing* 83 F. Supp.

But these remedies too are carefully circumscribed. A 16(b) action, for example, must be brought within two years from the time profits were realized.<sup>52</sup> And all profits recovered go to the corporation, not to the victimized buyers or sellers. Sections 9(e) and 18(a) are even more rigorous. Both contain a one-and-three year statute of limitations and under both a plaintiff may be required to post security for costs.<sup>53</sup> Both require the plaintiff to prove that the fraud or misrepresentation actually affected the price at which he bought or sold. Moreover, Section 9(e) requires a showing that the fraud was wilful, and 18(a) proof that plaintiff relied on the misstatement to his detriment. Finally, a defendant to an 18(a) action may easily avoid liability by showing that he acted in good faith and without knowledge.<sup>54</sup>

Therefore, the first real step toward protection of the seller came in 1936 when Section 15(c) was added to the Exchange Act.<sup>55</sup> The Section prohibited

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159 (S.D.N.Y. 1949); *Arbetman v. Playford*, 83 F. Supp. 335 (S.D.N.Y. 1949); *Benisch v. Cameron*, 81 F. Supp. 882 (S.D.N.Y. 1948); *Dottenheim v. Emerson Electric Mfg. Co.*, 7 F.R.D. 343 (E.D.N.Y. 1947).

For a general discussion of problems raised by § 16(b) see Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. OF PA. L. REV. 468 (1947); Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939); Comment, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 YALE L.J. 510 (1950). For a discussion of the problems raised by the interrelationship of §§ 10(b) and 16(b), see pages 1140-2 *infra*.

52. Recognizing the broad purposes underlying § 16(b), courts are likely to relax this requirement. *E.g.*, *Grossman v. Young*, 72 F. Supp. 375 (S.D.N.Y. 1947), where the court permitted the action to be maintained more than two years after the profits were realized because discovery of the insider's trading was necessarily delayed by alleged concealment and fraud on the part of the director.

53. Courts are obviously given this discretion in order to prevent holdup and frivolous suits. Where, as in *Stella v. Kaiser*, 81 F. Supp. 807 (S.D.N.Y. 1948), the court finds that the action was brought in good faith, the posting of security for costs will not be required even though plaintiff's holdings were a "minute fraction" of stock outstanding, and recovery would be "infinitesimal." See also *Acker v. Schulte*, 74 F. Supp. 683 (S.D.N.Y. 1947).

54. The difficult burden of proof which a plaintiff must assume undoubtedly accounts for the total absence of cases under Exchange Act § 18(a), even apart from the factors discussed in note 40 *supra*.

55. "(c) 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 . . . otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent." 49 STAT. 1378 (1936), as amended, 15 U.S.C. § 780(c) (1946).

In 1938, the Exchange Act was further amended. These 1938 amendments (the Maloney Act), 52 STAT. 1075 (1938), retained this section unchanged and merely renumbered it § 15(c) (1) by the addition of two additional sections, § 15(c) (2) and § 15(c) (3), which

fraud or misrepresentation in the purchase as well as the sale of securities, in contravention of SEC rules.<sup>56</sup> But under Rule X-15C1-2, the Commission permits a defendant to escape liability for misrepresentation if made without "knowledge" or with "reasonable grounds to believe," and under an amendment to Section 29(b) passed in 1938, actions under 15(c) (1) must be brought within one year after discovery and within three years after the violation occurred. Moreover, the section applies only to transactions otherwise than on an exchange and only to brokers and dealers. Consequently a sizeable gap still remained—fraud in the purchase of securities by persons other than brokers and dealers, and fraud in the purchase of securities effected on a national exchange. Yet this is perhaps the most important problem. The most devastating frauds against existing security holders are engineered by corporate insiders armed with secret information. Knowing that their corporation's securities are badly undervalued in the market, they can proceed quietly to buy them up and rake off the profits.<sup>57</sup> So long as the profits are not realized within six months, the insiders are immune from any of the specific liability provisions of the Securities Acts.

#### *The Comparative Beauties of a 10(b) Action*

If Rule X-10B-5 stood alone as a source of private civil remedies, its terms would be broad enough to blanket almost all malpractices in securities transactions. Seemingly, therefore, any activities creating liability under other sections of the Acts—11 and 12(2) of the Securities Act, and 9(e),

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merely authorized the Commission to adopt rules particularizing certain kinds of fraudulent conduct that would violate the Exchange Act. In this amendment process, Congress approved the nine rules, X-15C-1 to X-15C-9, which the Commission had adopted under § 15(c): "Under . . . [§ 15(c)], the Commission has adopted rules and regulations which have withstood the test of experience and have met with the approval of representative groups of brokers and dealers subject thereto." SEN. REP. NO. 1455, 75th Cong., 3d Sess. 10 (1938).

#### 56. *Rule X-15C1-2. Fraud and Misrepresentation.*

"(a) The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c) (1) of the Act is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

"(b) The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c) (1) of the Act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary to make the statements made, in the light of the circumstances under which they are made, not misleading, which statements or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

"(c) The scope of this rule shall not be limited by any specific definitions of the term 'manipulative, deceptive, or other fraudulent device or contrivance' contained in other rules adopted pursuant to section 15(c) (1) of the Act." 17 CODE FED. REGS. § 240.15c1-2 (1949).

57. See, e.g., *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947) discussed on pages 1150-1 *infra*; PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES, H.R. Doc. No. 672, 79th Cong., 2d Sess. (1946).

15(c) and 18(a) of the Exchange Act—would also lead to liability under Section 10(b).<sup>58</sup>

In comparison with other sections, an action under Section 10(b) is extremely attractive. Plaintiff has a relatively simple case: he need only show damages and, for example, a misstatement or omission of a material fact.<sup>59</sup> If all he asks is rescission, he need not even show damages. Nor is there a specific provision whereby he can be required to put up security for costs. In looking for a likely target—a defendant with money—he is not limited by a “privity” requirement. The phrase “in connection with the purchase or sale” apparently enables him to sue parties other than those immediately involved in the transaction that led to his loss, which he could not do as a buyer suing under Sections 12(1) and 12(2) of the Securities Act.<sup>60</sup> Moreover, the Rule makes no express provision for affirmative defenses.<sup>61</sup>

Finally, although it is not entirely clear just what statute of limitations does apply, a plaintiff proceeding under 10(b) would seem to be free of the “one-and-three-year” formula. The question is what statute to apply to an action involving a federal substantive right for which Congress has specified no period of limitation. The answer seems to turn on whether the

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58. See discussion and cases cited in note 85 *infra*. The doubtful issue, insofar as mere terminology is concerned, relates to Securities Act § 12(1). Failure to fulfill the registration and prospectus requirements of Securities Act § 5—for which § 12(1) creates civil liability—is not necessarily an act “which operates or would operate as a fraud or deceit” under Rule X-10B-5.

59. In an action under Exchange Act § 10(b), as in all civil liability sections of both the Securities Act and the Exchange Act, the plaintiff must show use of the mails or another instrumentality of commerce, since the very constitutionality of all federal securities legislation rests on the commerce clause, U.S. CONST. ART. 1, § 8, cl. 3. Under Securities Act § 12(2), it is not yet clear whether the actual misstatement or omission must itself occur in the use of the mails, *Kemper v. Lohnes*, 173 F.2d 44 (7th Cir. 1949); *cf. Siebenthaler v. Aircraft Accessories Corp.*, CCH FED. SEC. ACT SERV. ¶90,122 (W.D. Mo. 1940); *Curby*, *Civil Liabilities under the Securities Act of 1933*, 19 ST. LOUIS L. REV. 76, 82-3 (1933); or whether a use of the mails or other instrumentality of interstate commerce to effect the transaction, either before or after the misrepresentation, will suffice. *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943); *Moore v. Gorman*, 75 F. Supp. 453 (S.D.N.Y. 1948); *Douglas & Bates*, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 183 n.51. The latter and probably the better construction is approved in Note, 49 COL. L. REV. 1018 (1949), and has been consistently followed by the courts in interpreting Securities Act § 17(a), the model for Rule X-10B-5. *E.g., United States v. Monjar*, 147 F.2d 916 (3d Cir. 1944). See Loss, *op. cit. supra* note 3, at 182-7.

60. None of the other specific liability sections of the two acts have a privity limitation. Securities Act § 11 is particularly broad. For an enumeration of potential defendants under that section, see note 38 *supra*. For a discussion of the coverage of Rule X-10B-5, see note 87 *infra*.

61. In this respect, an action under Rule X-10B-5 is comparable to a suit for equitable rescission where plaintiff need show merely that material misstatements were made and innocence or “due care” is no defense. But on its face, Rule X-10B-5 is even better than common law rescission, since plaintiff need not tender back the securities and reliance need not be shown. Nevertheless, courts are likely to read certain defenses into Rule X-10B-5. See pages 1135-6 *infra*.

action is essentially "legal" or "equitable." The Supreme Court has held that where an action is legal,<sup>62</sup> or where the action though equitable is to enforce essentially a legal right, Congress intended the appropriate state statute to apply.<sup>63</sup> The usual state statute extinguishes an action after five or six years from the date of the offense.<sup>64</sup> On the other hand, the Court has also held that where a federal right is asserted and the *sole* remedy is in equity, the federal doctrine of "laches" supersedes the state statute of limitations.<sup>65</sup> Under this rule, plaintiff gets a reasonable time after his *discovery* of the fraud, unless the delay in discovery was due to a lack of care on his part.<sup>66</sup>

Apparently, most actions under 10(b) would be subject to the state statute without benefit of laches. Even though an action is brought as an equitable class action or as a suit for equitable rescission, the relief sought will usually be the "legal" relief of money damages.<sup>67</sup> Nevertheless, the

62. *Rawlings v. Ray*, 312 U.S. 96 (1941) and other cases cited in *Holmberg v. Armbrrecht*, 327 U.S. 392, 395 (1946). *But see* *Bailey v. Glover*, 21 Wall. 342, 349 (U.S. 1874) and note 65 *infra*.

63. *Cope v. Anderson*, 331 U.S. 461, 463-4 (1947).

"[W]hen the jurisdiction of the federal court is concurrent with that at law, or the suit is brought in aid of a legal right, equity will withhold its remedy if the legal right is barred by the local statute of limitations." *Russell v. Todd*, 309 U.S. 280, 289 (1940).

64. *E.g.*, N.Y. CIV. PRAC. ACT § 48(2) (six years from date cause of action accrued where suit is to "recover upon a liability created by a statute"). It may also be that N.Y. CIV. PRAC. ACT § 48(5) is applicable, however: "An action to procure a judgment on the ground of fraud" accrues on "discovery by the plaintiff . . . of the facts constituting the fraud." If so, it would make no difference in New York State whether an action were deemed legal or equitable; in either case, § 48(5) applies what would be laches in the federal courts. See also ILL. ANN. STAT. c. 83, § 16 (1949) (5 years from date cause of action occurred); *id.* § 23 (statute of limitations begins to run from date cause of action is discovered where its existence is fraudulently concealed). *But see* DEL. REV. CODE § 5129(6) (1935) (three year statute of limitations).

65. *Holmberg v. Armbrrecht*, 327 U.S. 392, 395 (1946). In an *amicus* brief filed in *Fifth-Third Union Trust Co. v. Block*, Civ. No. 1507, S.D. Ohio, Dec. 11, 1946 (no opinion), the SEC contended that the *Holmberg* rule should be applied to actions at law as well as in equity. The justification for laches, said the Commission, is as great in either case. Moreover, a single rule is particularly desirable "when it is considered that the two forms of action have been abolished and that legal and equitable claims and defenses can be combined in the same action." Brief for the SEC as *amicus curiae*, pp. 18-19, *Fifth-Third Union Trust Co. v. Block*, *supra* (mimeograph). See also Note, 49 YALE L.J. 738 (1940); Purcell, Foster & Hill, *Enforcing the Accountability of Corporate Management and Related Activities of the SEC*, 32 VA. L. REV. 497, 532-9 (1946). As a matter of policy, the SEC's view seems unanswerable. *But see* *Cope v. Anderson*, 331 U.S. 461, 463-4 (1947), decided after the SEC filed its brief in the *Fifth-Third* case, *supra*.

66. *See* *Holmberg v. Armbrrecht*, 327 U.S. 392, 397 (1946).

67. In almost all cases where a market exists for the securities, money damages

plaintiff is better off under 10(b) than under other provisions of the Securities Acts. Six years is twice as good as three.

Yet these virtues of a 10(b) action are available only if a 10(b) action is available, and only if the limitations applicable to the specific remedy sections are not read into 10(b) by the supposed dictates of statutory interpretation.

#### PROCEDURAL ASPECTS OF §10(b)

##### *A Private Right of Action?*

Defendants in private actions brought under Section 10(b) have consistently urged that Congress intended no such remedy. Explicit provision for private actions was made in three other sections of the Exchange Act, Section 9(e), 16(b) and 18(a). But there is no express provision for a private action under 10(b). The conclusion, say defendants, is inescapable: Congress didn't want one.<sup>68</sup>

Courts have not been persuaded by this line of argument. They are now inclined to "construe the details of an act in conformity with its dominating general purpose,"<sup>69</sup> which in the Exchange Act is to make protection of investors "reasonably complete and effective."<sup>70</sup> Moreover, the three specific civil remedies deal with only a small part of the field covered by the Exchange Act. Each supplies a substantive right unknown to common law, and each has special procedural provisions including a short statute of limitations. Congress may have spelled out these actions in detail merely for the purpose of imposing limitations which it did not want on actions under other provisions of the Act.<sup>71</sup> Finally, it is a well-established doctrine that where remedial legislation is concerned, "members of a class for whose

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would be an adequate remedy. Perhaps the only exception would be the case of a defrauded seller who had had control and seeks to regain it by tendering the sales price into court, on the ground that reacquiring control on the market could be accomplished only at inflated prices, if at all. Where a legal remedy is inadequate, actions under Rule X-10B-5 will presumably come within the *Holmberg* rule, *Holmberg v. Armbrrecht* 327 U.S. 392 (1946). See *Deckert v. Independence Shares Corp.*, 311 U.S. 282 (1940) (suit for rescission under Securities Act § 12(2)).

68. *E.g.*, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); *Osborne v. Mallory*, 86 F. Supp. 869, 878 (S.D.N.Y. 1949). This "*expressio unius est exclusio alterius*" argument is approved in Note, *SEC Action Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV. 769, 779 (1946).

69. *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-1 (1943).

70. Exchange Act § 2. See also Note, *New Civil Liabilities Under Securities and Exchange Act Rules*, 14 U. OF CHI. L. REV. 471, 474-5 (1947).

71. See *Baird v. Franklin*, 141 F.2d 238, 244-5 (2d Cir. 1944), *cert. denied*, 323 U.S. 737 (1944); Brief for the SEC as *amicus curiae*, *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947) (mimeograph, Feb. 1947).

protection a statutory duty is created may sue for injuries resulting from its breach."<sup>72</sup>

But the most persuasive reason for concluding that 10(b) creates a private cause of action is found in the Act itself. As originally enacted, Section 29(b) merely declared that all contracts which violate any provision of the Act, or any rule or regulation under the Act, shall be void.<sup>73</sup> In 1938, Congress passed an amendment to Section 29(b) imposing a short statute of limitations on actions brought for violations of Commission rules under Section 15(c) (1).<sup>74</sup> Since Section 15(c)(1), like Section 10(b), does not specifically provide for a private action, the implication of the amendment was that Congress had always assumed that private actions under those and similar provisions were available.

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72. Opinion of Clark, J., in *Baird v. Franklin*, 141 F.2d 238, 244-5 (2d Cir. 1944), *cert. denied*, 323 U.S. 737 (1944). See also *Bell v. Hood*, 327 U.S. 678 (1946); *Texas & Pac. Ry. v. Rigsby*, 241 U.S. 33, 39-40 (1916); PROSSER, *TORTS* § 39 (1941); HARPER, *TORTS* § 78 (1933); Note, *Federal Jurisdiction in Suits for Damages Under Statutes Not Affording Such Remedy*, 48 *COL. L. REV.* 1090 (1948): "[F]ederal courts have the power to afford all remedies necessary to the vindication of federal substantive rights defined in statutory and constitutional provisions, except where Congress has explicitly indicated that such remedy is not available. . . . Since under this rationale the federal courts have the power to award any appropriate remedy whenever a federal substantive right is asserted, the twofold jurisdictional requirement that a federal right be alleged and that the court have power to award the desired remedy, is satisfied by the mere assertion of a federal substantive right. . . . [A] federal court will determine on the merits the propriety, as a matter of 'national common law,' of awarding the remedy sought." *Id.* at 1094-5.

Moreover, courts have construed statutes providing only for criminal penalties as creating civil liability as well. See Morris, *The Relation of Criminal Statutes to Tort Liability*, 46 *HARV. L. REV.* 453 (1933); Lowndes, *Civil Liability Created by Criminal Legislation*, 16 *MINN. L. REV.* 361 (1932).

73. "Sec. 29 . . . (b) Every contract made in violation of any provision of this title or any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any rights thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation. . . ." 48 *STAT.* 903 (1934), 15 *U.S.C.* § 78cc(b) (1946).

74. "Sec. 29 . . . (b) . . . (A) . . . [N]o contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 15 of this title [see note 55 *supra*], and (B) . . . no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation." 52 *STAT.* 1076 (1938), 15 *U.S.C.* § 78cc(b) (proviso) (1946).

Therefore, courts have concluded that there is a private right of action not only under Section 10(b),<sup>75</sup> but also under Sections 6(b),<sup>76</sup> 7(a-d),<sup>77</sup> 11(d)(2),<sup>78</sup> 15(c)(1),<sup>79</sup> and 17(a)<sup>80</sup> of the Exchange Act and Section 17(a) of the Securities Act<sup>81</sup>—all of which lack express provision for private suits.<sup>82</sup>

#### *Meshing 10(b) with Companion Provisions of the Acts*

When the Securities Acts are construed as a whole, however, Section 10(b) does not provide an unlimited remedy. Appealing as the prospect might be, buyers and sellers clearly cannot use a 10(b) action to bypass the limitations contained in other provisions creating liability.<sup>83</sup> Sections 9(e),

75. *Slavin v. Germantown Fire Insurance Co. et al.*, 174 F.2d 799 (3d Cir. 1949) (private action expressly recognized by the court; judgment directed for defendant on other grounds); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (leading case discussing rationale of private actions for Rule X-10B-5 violations); *Fry v. Schumaker*, 83 F. Supp. 476 (E.D. Pa. 1947); *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123 (E.D. Pa. 1948); *McManus v. Jessup & Moore Paper Co.*, Civ. No. 8015, E.D. Pa., July 30, 1948 (no opinion); *Hall v. American Cone & Pretzel Co.*, 71 F. Supp. 266 (E.D. Pa. 1947); *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947); *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949); *Seward v. Hammond*, 8 F.R.D. 457 (D. Mass. 1948); *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949); *Acker v. Schulte*, 74 F. Supp. 683 (S.D.N.Y. 1947); *Montague v. Electronic Corp. of America*, 76 F. Supp. 933 (S.D.N.Y. 1948); *Stella v. Kaiser*, 82 F. Supp. 301 (S.D.N.Y. 1948); *Fifth-Third Union Trust Co. v. Block* Civ. No. 1507, S.D. Ohio, Dec. 11, 1946 (opinion in the form of short letter to counsel stating that the *Kardon* rule, *supra*, is being followed); *Grand Lodge of International Association of Machinists v. Highfield, et al.*, Civ. No. 3661-48, D.D.C., Jan. 24, 1949 (no opinion).

76. *Baird v. Franklin*, 141 F.2d 238 (2d Cir. 1944), *cert. denied*, 323 U.S. 737 (1944) (breach of duty on part of N.Y. Stock Exchange to discipline or suspend members for bad conduct gives rise to cause of action under Exchange Act § 6(b)).

77. *Remar v. Clayton Securities Corp.*, 81 F. Supp. 1014 (D. Mass. 1949) (failure to comply with margin requirements set by Federal Reserve Board); *Appel v. Levine*, 85 F. Supp. 240 (S.D.N.Y. 1948).

78. *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949) (failure to disclose to customer whether dealing for own account or as agent for that customer or another).

79. *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949) (material misrepresentation proscribed by Rule X-15C1-2).

80. *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949) (failure to submit reports prescribed by Rule X-17A-5).

81. *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949).

82. An alternative rationale used by courts is that Exchange Act § 29(b) itself provides a private right of action for violations of other sections of the Act. *Geismar v. Bond & Goodwin, Inc.*, 40 F. Supp. 876, 878 (S.D.N.Y. 1941); Note, 46 *MICH. L. REV.* 680 (1947). Cf. *Goldstein v. Groesbeck*, 142 F.2d 422, 427 (2d Cir. 1944).

83. "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).

15(c) and 18(a) of the Exchange Act were not inserted as window-dressing,<sup>84</sup> and there is no indication that in passing the Exchange Acts Congress had any intention of repealing the limitations in Sections 11, 12(1) and 12(2) of the Securities Act. If those sections are to be given any effect, it must be assumed that in a 10(b) action involving the same parties and the same offense covered by any one of them, the appropriate procedural limitations and defenses will apply.<sup>85</sup>

If 10(b) itself is to be other than mere surplusage, however, it cannot be

84. *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123 (E.D. Pa. 1948); *Montague v. Electronic Corp. of America*, 76 F. Supp. 933 (S.D.N.Y. 1948).

85. *Rosenberg v. Globe Aircraft Corp.*, 80 F. Supp. 123 (E.D. Pa. 1948) (plaintiff sued under Exchange Act § 10(b) for conduct also constituting violations of Securities Act §§ 11 and 12; held, § 10(b) creates a cause of action but the defenses and limitations of §§ 11 and 12 are applicable).

"The plaintiff answers that the registration statement and prospectus are manipulative and deceptive devices within the meaning of Sec. 10(b) of the Act of 1934. Assuming, without deciding, that they are, they are nevertheless a special type of manipulative or deceptive device as to which the Act of 1933 in Secs. 11 and 12 . . . has prescribed what amounts to a code of procedure, including venue provisions. It cannot be supposed that Congress intended to abolish these regulations and limitations when it enacted Sec. 10 of the Act of 1934. By any reasonable rule of statutory interpretation, it would require either an express repeal or an implication of repeal so strong as to be inescapable. The two Acts are unquestionably in *pari materia* [sic] and must be construed together to make a consistent whole. Looking at them as one statute, it is simply not possible that Congress, having prescribed in elaborate detail procedural requirements which must be fulfilled in order to enforce civil liability attaching to a carefully defined type of violation, would have casually nullified them all in a later section." *Id.* at 124. See also *Montague v. Electronic Corp. of America*, 76 F. Supp. 933 (S.D.N.Y. 1948). *Contra*: *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949) (complaints under Securities Act §§ 12(1) and 12(2) dismissed on ground that statute of limitations had run; complaint alleging same facts as violations of Securities Act § 17(a) and Exchange Act §§ 15(c) and 10(b) held not similarly barred). Judge Leibell's decision in the *Osborne* case, however, was rendered without discussion of the meshing problem and without reference to either the *Rosenberg* or *Montague* opinion.

Though both Judge Kirkpatrick in the *Rosenberg* case and Judge Coxe in the *Montague* case concluded that Rule X-10B-5 cannot be used by private parties to avoid the restrictions contained in the specific liability sections, they did so on different rationales. Judge Coxe decided that no § 10(b) action could be maintained where the specific liability provision furnished a remedy. Judge Kirkpatrick, on the other hand, decided that whether or not § 10(b) provided an alternative cause of action, the limitations and defenses of the appropriate specific remedy would be implied. And *Acker v. Schulte*, 74 F. Supp. 683, 686 (S.D.N.Y. 1947), squarely holds that the same facts may give rise to two separate causes of action—in that case under both Exchange Act § 9(c) and § 10(b). The SEC prefers the *Acker v. Schulte* approach. See Supplementary Reply Memorandum of SEC as *amicus curiae*, pp. 36-40, *Speed v. Transamerica Corp.*, Civ. No. 480, D. Del. (action now pending). If the Commission can proceed under X-10B-5, it has a broader choice of venue than is available in proceedings under the Securities Act. Compare Exchange Act § 27 with Securities Act § 22(a). Moreover, a violation of the Securities Act is not a ground for stock exchange expulsion under Exchange Act § 19(a)(3); and failure to comply with a subpoena under the Exchange Act is a misdemeanor, which it is not under the Securities Act. See Exchange Act § 21(c).

limited to the scope of the various special remedies. The purpose of 10(b) is to fill at least some of the "gaps" in investor protection. But what gaps? And should courts apply any of the procedural limitations and defenses of other sections to them too?

*The Gaps.* The minimum possible scope of 10(b), if it is to mean anything at all, is to give a defrauded seller a right of action analogous to that of a buyer under Section 12(2) of the Securities Act.<sup>86</sup> Filling this gap would bring the seller's bundle of rights up to par, without adding anything to those possessed by the buyer.

But so to limit the scope of 10(b) is to disregard the fact that the Section speaks of *sale* as well as purchase. It thus purports to give buyers as well as sellers some additional rights. One of these rights is freedom from the privity requirement which saddles Section 12(2) of the Securities Act. Unlike 12(2), which proscribes fraud only "in the sale of" securities, Section 10(b) makes unlawful any fraud "*in connection with*" the purchase or sale of securities.<sup>87</sup> It thus gives both buyers and sellers a right to sue persons who are not immediate parties to an offending transaction.<sup>88</sup>

86. *I.e.*, an action for express or implied misrepresentation in statements actually made, or fraud, where the purchaser is other than a broker or dealer, or where, if a broker or dealer, the transaction was effected on an exchange. Exchange Act § 15(c) (1) and Rule X-15C1-2 already provide (under the *Kardon* doctrine) for such an action by sellers against brokers and dealers for transactions effected other than on an exchange. See pages 1129-30 *supra* and notes 55-6 *supra*. It should also be noted that in this respect, at least, Securities Act § 12(2) and Exchange Act § 15(c) (1) overlap.

87. *E.g.*, *Slavin v. Germantown Fire Insurance Co.*, 174 F.2d 799, 809 (3d Cir. 1949) (last minute disclosure by purchaser of stock warrants to corporate directors relieved corporation and purchaser of liability to sellers of warrants); and see particularly *McManus v. Jessup & Moore Paper Co.*, Civ. No. 8015, E.D. Pa., July 30, 1948 (plaintiffs, minority stockholders of the Paper Co., complained that the sale by former majority stockholders and the management of their stock to the N.Y. Post Corp. at a large profit, was effected by fraud and to the detriment of the minority stockholders, who were not given an opportunity to sell at the same price. Though the plaintiffs were not parties to the sale transaction, Judge Bard entered an order denying a motion to dismiss, thus in effect holding that the complaint stated a good cause of action under Rule X-10B-5, and allowing the case to proceed to trial); *Hall v. American Cone and Pretzel Co.*, 71 F. Supp. 266 (E.D. Pa. 1947).

The following examples illustrate situations not covered by any of the present specific liability sections where Rule X-10B-5 may give rise to a cause of action:

(A) A corporate insider, in placing a purchase order with Broker *A*, withholds secret information that a security is worth twice its current market price. Broker *A* circulates a purchase order on the over-the-counter market or places an order on an exchange. Broker *B* solicits from investor *X* and fills *A*'s order, *A* in turn delivering to the insider. Investor *X* can sue the insider under Rule X-10B-5 for damages or rescission, even though the insider was not "privity" to the sale.

(B) The president of a corporation publishes misleadingly bearish information, in consequence of which Investor *X* sells to Investor *Y*, and Investor *Z* sells to the president himself. Both Investor *X* and Investor *Z* can sue the president—*X* for damages, *Z* for damages or rescission.

88. In this respect, § 10(b) is comparable to § 15(c) (1) which uses the same "in

In addition to providing sellers a cause of action for misrepresentation, and giving both buyers and sellers a broader slate of potential defendants, Section 10(b) and Rule X-10B-5 are designed to check activities for which none of the other provisions provide a remedy. The other sections cover misrepresentation and certain types of unsavory practices. Rule X-10B-5, on the other hand, not only prohibits express and implied misrepresentation in statements actually made, it also makes fraudulent business practices of *any* kind unlawful.<sup>89</sup> For example, a corporate insider with secret information places a purchase order with Broker A and makes no statements whatsoever. Broker A orders from Broker B who purchases from Citizen C. It later turns out that the security was worth three times the price paid. Mr. C is not the victim of misrepresentation as defined in 12(2) or X-10B-5. But he is certainly the victim of a fraudulent act under X-10B-5—absolute quiet about important secret information.<sup>90</sup>

In summary, Section 10(b) and Rule X-10B-5 may be fairly interpreted to fill three gaps: (1) they give a seller remedies already available to a buyer—a remedy for misrepresentation by parties other than brokers and dealers, and a remedy for misrepresentation or fraud by brokers and dealers in transactions effected on an exchange; (2) they supply a remedy for both buyer and seller against persons who, though responsible for a misrepresentation, were not immediate parties to the sale; and (3) they give both buyer and seller a remedy for fraudulent practices, old and new, not covered by other remedial provisions of the two Acts.

*The Limitations.* In these 10(b) actions which fill gaps should courts read in the "one-and-three-year" statute of limitations and any of the defenses found in the other specific liability sections? The strongest argument for doing so is that any other interpretation would create some rather surprising anomalies.

The defrauded seller in an action for misrepresentation would be placed in a much better position than a buyer under a 12(2) action, even though the offense committed by the defendant is substantially the same. Thus, a

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connection with" language and therefore permits a buyer of securities, for example, to sue a broker whose misrepresentation was responsible for an unfortunate purchase, even though that broker was not the one who made the actual purchase. See also Exchange Act § 15(c) (2), which is similar to § 15(c) (1) except that it does not apply to exempted securities (as defined in Exchange Act § 3(a) (12) ) and that it specifically forbids fictitious quotations.

89. Rule X-10B-5, particularly clauses (1) and (3). See also *McManus v. Jessup & Moore Paper Co.*, Civ. No. 8015, E.D. Pa., July 30, 1948, discussed note 87 *supra*; PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES, H.R. Doc. No. 672, 79th Cong., 2d Sess. 8, 36 (1946); *State v. Whiteaker*, 118 Ore. 656, 661, 247 Pac. 1077, 1079 (1926): "[There is always] a certain class of gentlemen of the 'J. Rufus Wallingford' type—they toil not, neither do they spin'— . . . [They] lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. . . ."

90. For a discussion of the duty of an insider to disclose under these circumstances see pages 1144-49 *infra*.

corporate insider might have sold his securities on the basis of secret information that the corporation was coming on hard times, or he might have purchased on the basis of information that a bonanza was in the offing. It would be somewhat strange if a three-year statute of limitations and a defense of reasonable care hampered the buyer in the first case, while the seller in the second case had the benefit of a six-year statute and no defense.

Similarly, it would be odd if buyers and sellers could sue parties not privy to a sale transaction at any time within six years, while immediate parties guilty of misrepresentation escape after three; and if defenses available to immediate parties were not available to others. The anomaly would be sharpened in an action against multiple defendants, all of whom were involved in approximately equal degree in the offense complained of, but some of whom would escape either because time had run or because of a defense of due care.

Consistency, however, is not the only aim of statutory interpretation. In undertaking to supply comprehensive protection for the ordinary investor, Congress felt sufficiently acquainted with certain problem areas to lay down fairly specific rules and regulations.<sup>91</sup> But Congress also recognized that "[i]n a field where practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent [ends],"<sup>92</sup> it was compelled to grant the SEC broad discretionary powers to deal by appropriate administrative rules with problems whose full import Congress could not anticipate.<sup>93</sup> Section 10(b) is one of those precautionary grants of broad rule-making power. The only problem of interpretation, therefore, is whether or not any particular rule is an abuse of discretion.<sup>94</sup>

Rule X-10B-5, a virtual reproduction of Section 17(a) of the Securities Act, is clearly within the scope of the Commission's power. The Commission could have inserted a "due care" defense proviso in Rule X-10B-5, as it did

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91. *E.g.*, Exchange Act § 6, dealing with the registration of national securities exchanges, and § 8, imposing detailed restrictions on borrowings by members of exchanges, brokers, and dealers.

92. H.R. REP. No. 1383, 73d Cong., 2d Sess. 6-7 (1934).

93. *E.g.*, Exchange Act § 14, and rules thereunder, regulating solicitation of proxies. See Latham & Emerson, *SEC Proxy Regulation: Steps Toward More Effective Stockholder Participation*, 59 *YALE L.J.* 635 (1950); Friedman, *SEC Regulation of Corporate Proxies*, 63 *HARV. L. REV.* 796 (1950).

94. See, *e.g.*, *NBC v. U.S.*, 319 U.S. 190 (1943) (FCC chain-broadcasting regulations sustained as being adopted in the "public interest"); *Federal Security Administrator v. Quaker Oats Co.*, 318 U.S. 218 (1943) (sustaining Federal Security Agency regulation redefining "farina"): "Under such provisions, we have repeatedly emphasized the scope that must be allowed to the discretion and informed judgment of an expert administrative body. . . . These considerations are especially appropriate where the review is of regulations of general application adopted by an administrative agency under its rule-making power in carrying out the policy of the statute with whose enforcement it is charged." *Id.* at 227-8. Cf. *Northwestern Electric Co. v. FPC*, 321 U.S. 119 (1944). See also Davis, *Administrative Rules—Interpretive, Legislative, and Retroactive*, 57 *YALE L.J.* 919 (1948).

in Rule X-15C1-2 with respect to brokers and dealers. It did not see fit to do so. In making this decision, the SEC cannot be said to have abused its discretion, even though anomalies should appear when various remedies are compared.<sup>95</sup>

This conclusion, however, does not mean that the SEC, or the courts in all situations and regardless of the parties involved, should leave a 10(b) action clear of the procedural limitations and defenses. The decision should depend to a great extent on the standards of behavior Rule X-10B-5 seeks to impose, and on whom.

*A Special Problem: Sections 10(b) and 16(b).* Sections 10(b) and 16(b) both apply to insider trading in a corporation's securities. But the causes of action created by the two sections are noticeably different in purpose and scope.

A Section 16(b) action is maintainable only against officers and directors of a corporation which has at least one class of equity securities listed on a national exchange; or against beneficial owners of ten per cent or more of such a corporation's listed equity securities.<sup>96</sup> A 10(b) action will run against "any person," which would seem at least to mean a broader category of

95. Some defendants in private actions under Rule X-10B-5 have unsuccessfully urged that § 10(b) ought to be confined to transactions in exchange-listed securities and transactions in unlisted securities in the over-the-counter market of brokers and dealers. *E.g.*, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); *Grand Lodge of International Association of Machinists v. Highfield*, D.D.C., Civ. No. 3661-48, Jan. 24, 1949 (no opinion) (both involving strictly private transactions). A motion to dismiss on similar grounds is now pending in *Robinson et al. v. Difford et al.*, Civ. No. 10322, E.D. Pa.

While the Exchange Act itself never defines "over-the-counter" market, Congress apparently meant the Act to regulate all kinds of securities transactions: "Under the Securities Exchange Act of 1934, the over-the-counter markets are deemed to include all transactions in securities which take place otherwise than upon a national securities exchange. . . ." H.R. REP. No. 2307, 75th Cong., 3d Sess. 2 (1938). Moreover, the definition of "security" in Exchange Act § 3(a)(10) includes instruments which could hardly be conceived of as subject to trading on an exchange or regular over-the-counter market. For example, the term includes "investment contract" which, in turn, has been construed by the Supreme Court to include a contract for the sale of citrus groves coupled with a collateral agreement for servicing by the seller. *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946). Finally, Securities Act § 17(a), upon which Rule X-10B-5 is patterned, see note 13 *supra*, has been repeatedly applied to "private" sales of securities. *E.g.*, *Bowen v. U.S.*, 153 F.2d 747 (8th Cir. 1946), *cert. denied*, 328 U.S. 835 (1946); *U.S. v. Monjar*, 147 F.2d 916 (3d Cir. 1944), *cert. denied*, 325 U.S. 859 (1945).

96. Exchange Act § 16(a) imposes on these individuals certain duties to report their securities transactions, designed to make § 16(b) effective. The Frear Bill, S. 2408, 81st Cong., 1st Sess. (1949), now before Congress, would extend the reporting requirements and liability provisions of § 16 to officers, directors, and controllers of corporations which, though they have no securities registered on a national exchange, have at least 300 security holders and \$3,000,000 in assets. See *Hearings before Subcommittee of the Senate Committee on Banking and Currency*, 81st Cong., 2d Sess. (1950); *A PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES*, 81st Cong., 2d Sess. (1950).

insiders.<sup>97</sup> Section 16(b) covers only those profits actually realized by a sale *and* purchase, or purchase and sale, within a six-months period. In contrast, a 10(b) action arises with either a purchase or sale. And plaintiff's relief is damages or rescission, not the net profits secured by the insider through later matching transactions. Section 16(b) applies only to transactions in *equity* securities, while 10(b) covers transactions in *any* security. A 16(b) action can be brought only by the corporation itself or by an existing security-holder, and recovery inures to the corporation.<sup>98</sup> A 10(b) action is brought by the outside investor for his own benefit. Profits are recoverable in a 16(b) action regardless of the intent with which the transactions were made, and regardless of whether or not there actually was fraud;<sup>99</sup> on the other hand, a plaintiff in a 10(b) action must show either fraud or misrepresentation. Finally, while a 10(b) action may be brought at any time within 5 or 6 years,<sup>100</sup> a 16(b) action, probably because of the harshness of automatic recovery, is cut off at the end of two.<sup>101</sup>

Save for the fact that 10(b) does not cover profits innocently made, it is by far the broader cause of action, so that in many cases there will be no conflict. But a given set of circumstances may create actions under both 10(b) and 16(b). Assume the following facts: an insider purchases 100 shares of stock from X for \$5,000, without disclosing secret information; five months later he sells the shares for \$10,000. Here the corporation can bring a 16(b) action and recover \$5,000, the profit realized on the purchase and sale. X can also recover \$5,000 in a 10(b) action for damages; or if prior to his suit the value of the shares has risen to \$12,000, he can recover \$7,000.

This seems to be double liability. In essence, however, it is not. The insider has simply run afoul of two distinct sections of the Exchange Act. His first transaction violated 10(b); his subsequent transaction brought him within the terms of 16(b). There is little reason for allowing him to escape one liability simply because he has managed to incur another. It would be strange indeed if in the above example X's rights under 10(b) could be cut

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97. See discussion page 1144 and notes 107 *et seq.*, *infra*. For a contrary view, see Note, *Purchase of Securities by "Any Person,"* 44 ILL. L. REV. 841 (1950).

98. The principle of Exchange Act § 16(b)—denial of insider profits—is also applied in Chapter X reorganizations, where the court is authorized to limit claims purchased by insiders during the course of proceedings to their actual cost. Bankruptcy Act, § 212, 52 STAT. 895 (1938), as amended, 11 U.S.C. § 612 (1946). The SEC may do the same thing in public utility reorganizations, *SEC v. Chenery Corp.*, 332 U.S. 194 (1947), and trustees are traditionally denied profits from transactions between themselves and their estates, *e.g.*, *Magruder v. Drury*, 235 U.S. 106 (1914).

99. Exchange Act § 16(b) is essentially a compromise. Actual proof of misuse of inside information is difficult, if not impossible to assemble, under common law standards. At the same time, many insider purchases are for legitimate, long-term investment purposes. Thus § 16(b) arbitrarily permits recapture of all profits, regardless of motive, if made within six months. See Comment, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 YALE L.J. 510, 511 (1950).

100. See pages 1132-3 and note 64 *supra*.

101. But see *Grossman v. Young*, 72 F. Supp. 375 (S.D.N.Y. 1947), and note 52 *supra*.

off at any time within six months by a second transaction with which he had nothing to do. It would be doubly strange if his rights could be cut off by the very party who was responsible for his loss. Similarly, there is no warrant for denying 16(b) liability merely because the insider has committed a fraud in either his purchase or sale. To do so would be to confine a 16(b) action to innocent transactions only—a bizarre result, to say the least. Of course, an insider may argue that as a result of having to pay *X*, he has made no profit at all and is thus immune from Section 16(b). But this argument deserves short shrift. The word “profits” in 16(b) is not defined as net after deduction of losses in a law suit.<sup>102</sup>

Apparently, therefore, Section 10(b) can be allowed full sway without creating a clash with Section 16(b).<sup>103</sup>

#### DUTY OF DISCLOSURE UNDER X-10B-5

By its terms, Rule X-10B-5 makes it unlawful for *any* person to indulge in express or implied misrepresentation of a “material fact,” employ any scheme to “defraud,” or engage in any practice which operates as a “fraud or deceit.” These terms have a long history of usage in common law.<sup>104</sup> Nevertheless, the courts have held that X-10B-5 is not bounded by common law standards.<sup>105</sup> Otherwise, as the second circuit pointed out in reject-

102. See *Hall v. American Cone & Pretzel Co.*, 71 F. Supp. 266 (E.D. Pa. 1947); *Rubin & Feldman*, *supra* note 51, at 468, 496–7, 497 n.88. For a similar argument that a § 16(b) action is independent of, and does not preclude, a common law recovery for fraud, see *Yourd*, *supra* note 51, at 149 n.56. This view is buttressed by Exchange Act § 28(a) which provides that “the rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity. . . .”

103. Where the facts are such that both a § 10(b) and a § 16(b) action can be brought, the party suing under § 10(b) must still show fraud or misrepresentation. Thus, he is faced with some of the same difficulties of proof that led Congress to provide automatic recovery under § 16(b). These burdens under § 10(b), however, are much lighter than they were at common law.

104. See generally *Shulman*, *supra* note 19, at 227–42, and articles collected *id.* at 233 n.17.

105. See note 18 *supra*. It has been held that the mail fraud statute, 18 U.S.C. § 1341 (1948), is not limited to common law fraud. See *Deaver v. United States*, 155 F.2d 740, 744 (D.C. Cir. 1946), *cert. denied*, 329 U.S. 766 (1946); *United States v. Groves*, 122 F.2d 87, 90 (2d Cir. 1941), *cert. denied*, 314 U.S. 670 (1941). Yet the mail fraud statute is not nearly so broad as the anti-fraud provisions of the Securities Acts. And in still other contexts courts have recognized that the term “fraud” when used in specialized securities statutes is not to be limited to common law concepts. Thus, in construing the Martin Act, N.Y. GEN. BUS. LAW Art. 23–A, which in general terms outlaws fraudulent practices in securities transactions, the New York Court of Appeals held that the terms “fraud” and “fraudulent practices” should not be limited by common law deceit standards, but should include “all deceitful practices contrary to the plain rules of common honesty.” *People v. Federated Radio Corp.*, 244 N.Y. 33, 38, 154 N.E. 655, 657 (1926).

ing a traditional definition of the terms of Rule X-15C1-2, "we should leave such legislation little more than a snare and a delusion."<sup>105</sup>

But if Rule X-10B-5 bursts through the confines of common law, how far does it go? Literally speaking, the rule imposes a new duty of disclosure on "any person," and the SEC has insisted that "any person" means "any person," at least for purposes of bringing an action.<sup>107</sup> But this does not necessarily mean that all persons against whom an action may be brought have the same duty of disclosure. There is good reason to believe that the scope of this duty will vary directly with an individual's opportunities to profit at the amateur investor's expense. Opportunities for abuse vary with a person's position. Corporate insiders are usually in the best position to obtain information concerning a security's worth.<sup>108</sup> Brokers and dealers, though less favorably situated, are in a position far superior to that of the ordinary investor.<sup>109</sup> Therefore, the corporate insider and the corporation may have a broader duty to disclose than that owed by independent brokers and dealers, who in turn have a broader duty than that owed by the ordinary in-and-out investor, who may in their turn have no higher duty to disclose than that imposed by common law, which was usually no duty at all. But this classification is not rigid. In a variety of situations, persons other than corporate officers and directors may have an "insider's" access to im-

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106. *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 438 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944), 18 ST. JOHNS L. REV. 134 (1944).

107. See, e.g., Supplemental Reply Memorandum of SEC as *amicus curiae*, p. 17 *et seq.*, *Speed v. Transamerica Corp.*, Civ. No. 480, D. Del. (trial on merits now pending). But see Note, *Purchase of Securities by "Any Person,"* 44 ILL. L. REV. 841 (1950) which concludes that "'any person' does not mean any person," and that the sanctions of the Exchange Act and Rule X-10B-5 "still apply only to insiders and broker-dealers." *Id.* at 845. This conclusion was based primarily on *Slavin v. Germantown Fire Insurance Co.*, 174 F.2d 799 (3d Cir. 1949), a decision which seems to say quite the contrary. Though the court found that the principal defendant was neither an officer nor a director, the cause of action under Rule X-10B-5 was sustained. Defendant escaped liability for failure to state material facts only because of a "last minute" disclosure, and even then only over a strong and persuasive dissent by Chief Judge Biggs, who felt that the majority was unduly limiting the duty of disclosure under X-10B-5, and the category of individuals owing such a duty.

108. The SEC has used Rule X-10B-5 primarily to prevent or repair the damage caused by purchase deals originating with corporate insiders. See, e.g., *In re Ward La France*, 13 S.E.C. 373 (1943); *SEC v. Boyd Transfer & Storage Co.*, Civ. No. 1548, D. Minn., Dec. 5, 1945 (case settled by consent decree); Note, *SEC Action Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV. 769 (1946).

109. The earlier doctrine, covering brokers and dealers, was established in proceedings under Securities Act § 17(a) and Exchange Act § 15(c), and rules thereunder, particularly Rule X-15C1-2. But the SEC has also put Rule X-10B-5 to use against brokers and dealers. See, e.g., *Norris & Hirshberg, Inc. v. SEC*, 177 F.2d 228 (D.C. Cir. 1949); *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); In the Matter of M. S. Wien, Exchange Act Release No. 3855 (Sept. 17, 1946).

portant information, and thus be charged under Rule X-10B-5 with a stringent duty to disclose.

It is particularly within the field of corporate insider operations that Rule X-10B-5 is likely to become a device for imposing steadily stricter standards of performance. Thus far the SEC and the courts have dealt only with the grosser variety of insider killings. But the principles which these cases have evolved may readily and logically be extended to other activities heretofore considered part of the corporate game. The duty imposed on insiders and corporations may well become that of full disclosure, in the "fullest" sense of the word.

### *The Duty of "Insiders"*

A fairly wide group of persons are in a position to receive private information concerning a corporation's affairs. Since those persons are thereby in a "bargaining" position superior to that of the ordinary investor, they all deserve the infelicitous honor of being dubbed "insiders" for purposes of disclosure under Rule X-10B-5.<sup>110</sup>

This group should clearly include the officers and directors of a corporation, and anyone in control of a corporation, whether directly or indirectly.<sup>111</sup> At the very least, it should also include members of their immediate families.<sup>112</sup> Similarly, any persons who pick up private information in the course of business negotiations with a corporation must be considered "insiders" as long as that information remains private. Thus, where Corporation *A* plans to buy out Corporation *B*'s assets or securities at a high price, a director of Corporation *A* is an "insider" in purchasing Corporation *B*'s undervalued securities. Finally, any "outsider," such as a broker or dealer, becomes an "insider" when he participates in a scheme hatched by other insiders to utilize private information in the purchase or sale of securities.<sup>113</sup>

110. In this connection, *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799 (3d Cir. 1949), seems overly restrictive. See note 107 *supra*.

111. See, *e.g.*, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). These individuals are already subject to the reporting requirements of Exchange Act § 16(a), 48 STAT. 896 (1934), 15 U.S.C. § 78p(a) (1946); they are prohibited from acting as trustee under a trust indenture, Trust Indenture Act § 310(b), 53 STAT. 1158-61 (1939), 15 U.S.C. § 77jjj(b) (1946); and they must be named in the registration statement for new security issues, Securities Act § 7, Schedule A(4), (5), and (6), 48 STAT. 84 (1933), as amended, 15 U.S.C. § 77g (1946).

112. Otherwise the sanctions of Rule X-10B-5 could be easily by-passed. Cf. *MOORE & OGLEBAY, CORPORATE REORGANIZATION* § 13.18 (1948). *But see In re Calton Crescent*, 173 F.2d 944, 950-1 (2d Cir. 1949), 59 YALE L.J. 151 (1949), where the court said that even if a restriction were imposed on the trading activities of directors of an insolvent concern, the restriction would not extend to members of their families purchasing for themselves with their own funds. Since the claims of the directors were allowed in full, the Supreme Court on review found it unnecessary to determine the issue. *Manufacturers Trust Co. v. Becker*, 70 S.Ct. 127, 133 n.16 (1949).

113. See, *e.g.*, *In the Matter of M. S. Wien*, Exchange Act Release No. 3855, pp. 13-22 (Sept. 17, 1946) (member of brokerage firm sat in on company meetings).

To whom do insiders owe the duty to disclose? Even under common law, some courts have held that officers and directors owe a "fiduciary" duty to stockholders, and have required full disclosure of all material facts in any transaction involving the corporation's own stock.<sup>114</sup> In its own proceedings, and as *amicus curiae* in private actions, the SEC has appropriated this rule to X-10B-5 and made it applicable to any insider.<sup>115</sup> Moreover, without any common law precedent, the Commission has applied the same standard when the insider purchases debt securities of the corporation.<sup>116</sup> The purpose of the Securities Acts is to protect investors generally. Most of their provisions make no distinction between stocks and debt securities.<sup>117</sup> And there is no ground for distinction in Rule X-10B-5. When a corporation is insolvent or skirting the edges of insolvency, its debt securities frequently are selling at a much heavier discount than insider information indicates is justified.<sup>118</sup> In these situations, bondholders can be taken for as big a ride as uninformed stockholders. As in the case of stockholders, there is no warrant under X-10B-5 for letting the insider make private profits at their expense.

When trading in any of his corporation's securities, therefore, the insider must disclose all "material facts." As used in X-10B-5 these terms, like "fraud" and "deceit," are not to be confined to common law treatment which in effect turned "material" and "fact" into escape hatches for defendants.<sup>119</sup> Generally, a material fact is any piece of information having fairly predictable results either on the value of the securities or on the outsider's estimate of that value. The term includes an as-yet-undisclosed sale contract of part or all of the corporation's assets or stock at a price

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114. See note 35 *supra*.

115. "The Commission has consistently construed Rule X-10B-5 as applicable to insiders trading in securities of a corporation who have failed to disclose facts known to them by reason of their position as insiders which would materially affect the judgment of the other party to the transaction. . . ." Brief for the SEC as *Amicus Curiae*, p. 3, *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947), citing *inter alia* SEC v. Boyd Transfer & Storage Co., Civ. No. 1548, D. Minn., Dec. 5, 1945, SEC Litigation Release No. 295 (Aug. 20, 1945), SEC Litigation Release No. 308 (Dec. 7, 1945); *In re Ward La France*, 13 S.E.C. 373 (1943), SEC v. H. P. Mueller, Civ. No. 2022, E.D. Wis., April 20, 1945, SEC Litigation Release No. 264 (March 28, 1945); SEC Litigation Release No. 268 (April 21, 1945).

116. *E.g.*, SEC v. Greenfield, Civ. No. 5361, E.D. Pa., April 2, 1946 (dismissed on stipulation containing offer of rescission to defrauded debenture holders). Apparently, directors were never under a duty at common law to disclose material facts to bondholders.

117. See definition of "security," Securities Act § 2; Exchange Act § 3(a)(10). Both definitions include "stock," "bond," "debenture," and a wide variety of certificates of indebtedness. Only Exchange Act § 16(b), which applies only to equity securities, makes any distinction between "stocks" and "bonds."

118. In SEC v. Greenfield, Civ. No. 5361, E.D. Pa., April 2, 1946, debentures with a face value of \$1,130 were selling at from \$450 to \$520. When the appreciation in value of the companies portfolio securities was taken into account, the book value of the debentures was \$750. This information was not disclosed to debenture holders.

119. See cases collected in Shulman, *supra* note 19, at 237 nn.31-43 (1933).

different from book value, or a firm offer to buy at such a price.<sup>120</sup> It also includes current and past net earnings per share and current book value per share; and with respect to unlisted securities, the current over-the-counter market price of the stock or bond.<sup>121</sup> The insider should disclose any important discrepancies between actual value and book value of fixed assets, inventory or any other assets such as securities (1) where the increased value (or the loss) is likely to be realized by sale in the near future,<sup>122</sup> or (2) where increased value (or depreciation) is likely to be permanent.<sup>123</sup> Moreover, he should disclose any recent events having an important bearing on the future health of the corporation—a large government order, a new oil strike, or the expiration of a basic patent. The “materiality” of the above facts and the need that they be disclosed are fairly clear.<sup>124</sup>

Disclosure of certain other material facts, however, raises problems. Thus, the identity of the insider who is either purchasing or selling is “material” enough: it may well cause the public investor to take a considerably different outlook on the transaction, since insiders too often speculate on the basis of private knowledge or judgment of the securities’ worth.<sup>125</sup> But it can be argued that the market will overestimate the importance of the insider’s trading, creating an excessive price fall when he sells and an overly exuberant price rise when he buys. Moreover, the insider may be getting out for reasons quite unrelated to the prospective value of the securities,<sup>126</sup> and he may be buying in for investment or control purposes rather than as a speculator.

Nevertheless, it would seem on balance that the identity of the insider should always be disclosed. Excessive market price reactions will tend to be checked by the subsequent reactions of the insider himself. Thus, where the current market price is 100, and the insider starts buying on the basis of private information that the true worth is 120, he will cease purchasing when market price hits 120 and the momentum generated by his activities will

120. See, *e.g.*, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); *McManus v. Jessup & Moore Paper Co.*, Civ. No. 8015, E.D. Pa., July 30, 1948.

121. *SEC v. Mueller*, Civ. No. 2022, E.D. Wis., April 20, 1945, SEC Litigation Release No. 264 (March 28, 1945), SEC Litigation Release No. 268 (April 21, 1945) (net earnings, book value); *SEC v. Mitchell*, Civ. No. 23097, N.D. Ohio, Aug. 6, 1945, SEC Litigation Release No. 288 (July 11, 1945), SEC Litigation Release No. 291 (Aug. 7, 1945) (current market price).

122. See, *e.g.*, *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947) (complaint alleged non-disclosure of inflation in value of tobacco inventory subsequently sold; motion to dismiss overruled).

123. *E.g.*, *SEC v. Greenfield*, Civ. No. 5361, E.D. Pa., April 2, 1946 (failure to disclose increased value of portfolio securities; dismissed on stipulation of offer to rescind).

124. For further discussion, see *Berle*, *supra* note 35, at 837.

125. For a parade of examples, see *Hearings before Senate Committee on Banking and Currency on S. 84, S. 56, and S. 97*, 72d Cong., 1st and 2d Sess.; 73d Cong., 1st and 2d Sess. (1932-4) *passim*.

126. For example, because of a change in management or incompatibility with present directors; in order to get funds for investment elsewhere; or to meet financial reverses.

soon play out. Disclosure of identity, in other words, will tend to make market price a more accurate reflection of true worth, which is what markets are supposed to do.

Moreover, in cases where the insider is liquidating for reasons unrelated to speculative profit, publicity of *those* facts should prevent undue distortion of market price. This may not be so true in the reverse case where the insider is investing heavily in order, for example, to get control. The price may rise unduly, and any public investor who buys in at the inflated price is likely to be hurt in the subsequent readjustment. But if in the process all other material facts have been disclosed, the public investor who buys is hurt by his own poor judgment, and under a pure disclosure theory is not deserving of recovery.

A more serious problem is presented by material facts concerning secret processes or plans which the legitimate business interests of the corporation dictate should not be disclosed.<sup>127</sup> Here the "fiduciary" duty owned by directors to their corporation seems to conflict with the duty of open and fair dealing owed public stockholders in the purchase and sale of securities. The apparent conflict can be resolved, however, by barring the insider from dealing in his corporation's securities whenever material facts should be kept secret in the corporation's best interests. In other words, fair dealing means "no dealing" when facts affecting the value of securities must be kept secret from the ordinary investor.<sup>128</sup> A contrary rule would shatter the protective armor which Rule X-10B-5 draws around the public security holder. For the insider can almost always present a plausible argument that this or that fact was kept secret "in the best interests of the corporation"; even as in the reverse case, the insider probably could easily establish that disclosure of the same fact was within the scope of reasonable business discretion, should a stockholder claim that disclosure violated the insider's duty to his corporation.<sup>129</sup>

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127. See Berle, *supra* note 35, at 837-8.

128. "It might be that the director is in possession of information which his duty to the company requires him to keep secret; and if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director can not be published, it does not follow that he may use it to his own advantage, and to the disadvantage of one whom he also represents. The very fact that he can not disclose prevents him from dealing with one who does not know, and to whom material information can not be made known." *Oliver v. Oliver*, 118 Ga. 362, 368, 45 S.E. 232, 234 (1903).

Professor Berle apparently would allow the director to trade under these circumstances, leaving it to the courts to determine, case by case, whether or not the facts were of a kind which corporate interest required not to be disclosed. Berle, *supra* note 35, at 837-8.

129. "Questions of policy of management . . . are left solely to [the directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient." *Pollitz v. Wabash R.R.*, 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912).

On the other hand, an insider is under no duty to give the ordinary investor the benefit of his specialized interpretive ability. Even though a shrewd guess by an insider is often worth fifty accounting statements, it would be highly unfair to make him publicize his guess and then to hold him responsible if it turns out to be wrong. It may even be said that in contrast to common law, under which misleading opinions created no liability, Rule X-10B-5 imposes on an insider a duty *not* to render advisory opinions. As a practical matter, the insider who is trading for speculative purposes will communicate views which distort rather than clarify the prospective value of the securities; and the public investor is more likely to be misled by an insider's "opinion" than by his misrepresentation of certain material "facts."<sup>130</sup>

Given a duty to disclose, how careful must the insider be in acquainting himself with all pertinent facts concerning a corporation's status? Is his responsibility absolute, or is he held only to some standard of reasonable care? An absolute standard undoubtedly would give greater protection to ordinary investors. Practically speaking, a "due care" standard invites a deluge of friendly testimonial evidence which plaintiffs would find difficult to rebut. Moreover, a stiff rule might improve a corporation's well-being by compelling the insider to keep a closer watch over the management of its affairs.<sup>131</sup> On the other hand, an absolute standard would be an extremely discouraging duty to impose on all insiders, particularly when the terms "insider" and "material fact" are given the broad definitions which Rule X-10B-5 would seem to require.<sup>132</sup>

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"Indeed, although the concept of 'responsibility' is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest." *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

On the "business judgment" rule generally, see BALLANTINE, CORPORATIONS §§ 63(a), 63(b) (rev. ed. 1946).

130. Despite the usual common law rule that one is not entitled to rely on statements of opinion, PROSSER, TORTS § 89 (1941), exceptions are frequently made where a party stands in a "fiduciary" relationship to another, *i.e.*, where a party is in the position of having special knowledge not available to the one with whom he deals. In this situation, his opinion "becomes in effect an assertion summarizing his knowledge," PROSSER, *op. cit. supra*, at 761, and will naturally and justifiably be heavily relied upon. *Sluss v. Brown-Crummer Inv. Co.*, 143 Kan. 14, 18; 53 P.2d 900, 903 (1936) (bonds "gilt-edge," "safe and sound"); *Edmonds v. Wilcox*, 178 Cal. 222, 172 Pac. 1101 (1918) (value of stock).

131. The law frowns on the "dummy director." Directors are generally required to participate in the management of a corporation, at least to the extent of acquainting themselves with enough facts so that they can vote intelligently at director's meetings. See, *e.g.*, *Kavanaugh v. Gould*, 223 N.Y. 103, 119 N.E. 237 (1918); BALLANTINE, CORPORATIONS §§ 62, 63 (rev. ed. 1946); 3 FLETCHER, *op. cit. supra* note 34, § 1090; Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934). But much of the sting of these requirements is removed by the rule which throws on plaintiff corporation or shareholder the burden of proving that a director's negligence probably caused the loss suffered, *i.e.*, that due care by the director would probably have prevented the loss. *E.g.*, *Barnes v. Andrews*, 298 Fed. 614 (S.D.N.Y. 1924).

132. See pages 1144-6 *supra*.

It is suggested as a compromise, therefore, that the insider's duty be to make a reasonable investigation of the facts; that the standard of reasonableness should be stringent in view of the ease with which the insider can get the facts; and that in any case where the insider has misstated or failed to supply a material fact, plaintiff have the benefit of a presumption that the insider breached his duty—a presumption entitled to be weighed as evidence. In the vast majority of cases, such a rule would accord plaintiffs ample protection. An insider would find it properly difficult to establish that he did not know and could not reasonably have known a fact so material that it influenced substantially the true worth of a security.

Finally, what means can an insider use to get material facts to the public investor? The principal difficulty involves securities listed and traded on a national exchange. Here the usual transaction is impersonal. It would be impracticable if not impossible to require disclosure of identity and individualized delivery of information to every public investor with whom an insider deals.<sup>133</sup> But this should not relieve insiders of the duty to disclose.<sup>134</sup> An adequate alternative is available: full publicity of material facts via the release of corporation accounts, reports or special announcements should suffice to protect investors.<sup>135</sup> Even though the investor who buys from or sells to the insider may not personally have received the information, the effect of the publicity will almost invariably have been reflected in price adjustments on the stock exchange. In the securities business, word gets around fast.

#### *Duty of Corporations in the Purchase or Exchange of Their Own Securities*

Rule X-10B-5 applies to purchase and sale by corporations as well as by insiders. Where the sale of new securities is subject to the registration and prospectus requirements of the Securities Act, X-10B-5 adds nothing. Nor does the Rule, though applicable, seem of great significance with respect to those security issues exempted from the formal requirements of the Act because other safeguards are available.<sup>136</sup> But where the issue is exempt

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133. See BALLANTINE, CORPORATIONS 215 (rev. ed. 1946). The same problem characterizes over-the-counter trading of securities widely held.

134. "Dishonest directors should not find absolution from retributive justice by concealing their identity from their victims under the mask of the stock exchange." BALLANTINE, CORPORATIONS 216 (rev. ed. 1946). See also Berle, *supra* note 35, at 830-1; Comment, *Duty of Director to Stockholder on Stock Exchange Sales*, 32 MICH. L. REV. 678, 684 (1934). But *cf.* Walker, *supra* note 35, at 644.

135. Berle, *supra* note 35, at 835; Comment, *Duty of Director to Stockholder on Stock Exchange Sales*, 32 MICH. L. REV. 678, 683-4 (1934).

136. For example, securities issued by a common carrier are exempt under Securities Act § 3(a)(6) because these issues are subject to prior approval by the Interstate Commerce Commission under Interstate Commerce Act § 20(a), 41 STAT. 494 (1920), as amended, 49 U.S.C. § 20(a) (1946); and securities issued in exchange for outstanding securities or for securities and cash are exempt under Securities Act § 3(a)(10) when the "terms and conditions of such issuance and exchange are approved, after a hearing . . . by any court, or by any official or agency of the United States, or by any State or

because it is small, or because it is purchased entirely by residents of one state, the Rule may well require disclosure comparable to that of a prospectus.<sup>137</sup>

The most important implications of Rule X-10B-5, however, pertain to purchase by a corporation of its own outstanding stock or debt securities, and to exchanges of one form of security for another. The case of *Speed v. Transamerica Corporation*<sup>138</sup> provides a strong hint as to how deeply the rule may bite. Briefly the alleged facts were these.<sup>139</sup> Axton-Fisher Tobacco Company had outstanding two classes of common stock, both with voting rights: a Class B common, and a Class A common callable at \$60 plus accrued dividends and convertible at holder's option into Class B. In 1941, the Company was apparently insolvent. In fact, however, it had a large tobacco inventory which had so appreciated in value as a result of the war that a sizeable equity existed over and above the corporation's debts. This inventory appreciation came to the attention of the Transamerica Corporation, which quickly thereafter acquired 71 per cent of Axton-Fisher's Class B common, representing 47 per cent voting control. Early in 1942, Transamerica followed up by offering Class A stockholders \$40 per share, and on acquiring a large block of Class A it immediately converted the shares into Class B. Then in April 1943, Axton-Fisher, now a puppet in the hands of Transamerica, called all remaining Class A common at \$60 plus \$20.80 accrued dividends. With the Class A out of the way, the Company liquidated its tobacco inventory, and distributed the proceeds to the Class B.

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Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval."

In addition, the Act exempts some security issues even where the safeguards of prior approval are absent. For example, Securities Act § 4(1) exempts "transactions by an issuer not involving any public offering." At the time the Act was passed, sizeable private placements were unknown. Hence there was not enough public interest in private offerings to warrant registration. While the rapid growth of large private placements with insurance and investment companies has made this rationale obsolete, the exemption can still be justified on the ground that these purchasers are quite capable of taking care of themselves.

137. *E.g.*, Securities Act § 3(a)(11), which exempts from the registration and prospectus requirements "any security . . . sold only to persons within a single state . . . where the issuer is a person . . . or corporation . . . doing business within such state. . ."; Securities Act § 3(b), which authorizes the Commission by rule to exempt issues of \$300,000 or less. Since these distributions are equally susceptible to the dangers which the Securities Act is designed to prevent, and since no alternative safeguards justify these exemptions, Rule X-10B-5 might well be invoked to afford investors protection should fraud or misrepresentation occur. Such a construction, of course, is consistent with the anti-fraud provisions of Securities Act § 17, which is specifically made applicable to transactions in exempted securities. Securities Act § 17(c).

138. 71 F. Supp. 457 (D. Del. 1947).

139. The facts are drawn from the opinions in the related cases, *Geller v. Transamerica Corp.*, 53 F. Supp. 625 (D. Del. 1943), and *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947), 36 CALIF. L. REV. 325 (1948), 46 MICH. L. REV. 1061, 1062 (1948), 96 U. OF PA. L. REV. 276 (1948).

These proceeds amounted to \$200 per share, a delightful profit for Transamerica, but a saddening loss to the deluded sellers of both Class A and Class B stock, none of whom had been supplied with any information concerning the real value of their shares.<sup>140</sup>

Mr. Speed, an erstwhile stockholder, took a particularly dismal view of this outcome. He therefore sued Transamerica under Rule X-10B-5 and for common law breach of duty. The federal district court granted defendant's motion for summary judgment on the common law count, holding that insiders were under no duty to disclose the facts which made this profit possible. But the court overruled a similar motion for dismissal of the count under X-10B-5 and allowed the case to proceed to trial.<sup>141</sup>

To be sure, the action was brought against an insider, not Axton-Fisher itself, and it involved what a commentator has called an "outrageous fraud." But could not Axton-Fisher also have been sued by the stockholders from whom it bought? And are not many situations in which a corporation purchases its own securities merely less colorful variations of the *Transamerica* case?

A substantial number of corporate "self-purchases" are obviously and unashamedly for the purpose of benefitting remaining shareholders.<sup>142</sup> Where those securities are callable at the corporation's option, the holders who are forced to sell can usually make no complaint for nondisclosure—perhaps indeed it would be better for their peace of mind if they didn't know.<sup>143</sup> But in a wide variety of situations, the shareholder has a choice and is thus vulnerable to fraud—where there is an option to convert into another class of securities;<sup>144</sup> where the corporation purchases non-callable

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140. It was alleged that neither Transamerica, in purchasing for its own account, nor Axton-Fisher, in redeeming the Class "A" stock, had disclosed the actual value of the inventory or the prospective liquidation of the company. *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947).

141. *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947).

142. A typical case involves the repurchase of preferred shares in order to eliminate dividend arrearages and liquidation preferences—all for the benefit of common stockholders. See, e.g., the activities of the Curtis Publishing Company, judicially sanctioned in *Johnson v. Fuller*, 121 F.2d 618 (3d Cir. 1941), but catalogued and disapproved in an excellent Note, *Purchase by a Corporation of Its Own Preferred Shares With Dividends in Arrears*, 14 U. OF CHI. L. REV. 66 (1946), on which the following text discussion of a corporation's duty to disclose heavily relies.

143. *But see* Note, 14 U. OF CHI. L. REV. 66, 72 (1946): "However, where palpable unfairness is authorized by the terms of the reservation [of power to repurchase], it may well be invalidated as repugnant to the basic obligation of fair treatment which the directorate owes to the preferred shareholder. Moreover, such a reservation of power should not bar relief when repurchases are a part of a conscious program to depress market prices by withholding dividends since it could hardly be urged that the corporation had by contract secured this power to defraud the preferred shareholder. Finally, despite the explicit reservation, in cases where the corporation failed to disclose both that it was the purchaser and relevant facts regarding current and prospective financial conditions, the preferred shareholder could base his claim for relief on nondisclosure by the fiduciary."

144. As was the situation with respect to Axton-Fisher's Class "A" common. *Zahn v. Transamerica Corp.*, 162 F.2d 36, 39 (3d Cir. 1947).

stock out of surplus;<sup>145</sup> where it purchases debt securities at a discount;<sup>146</sup> and where it offers to exchange a new security for an outstanding class of preferred stock or bonds.<sup>147</sup> Similarly, where an exchange is made in the process of a corporate merger, the holder of the superseded security has the option either to accept the new security or to get cash appraisal value on his old share.<sup>148</sup>

Where the security holder has any of these options—to sell or to convert, to sell or not to sell, or to exchange or not to exchange, etc.—he is then entitled under the principles of Rule X-10B-5 to full disclosure of all material facts bearing on his decision.<sup>149</sup> A shareholder or bondholder is as effectively

145. *E.g.*, *In re Ward La France*, 13 S.E.C. 373, 376 (1943).

146. *E.g.*, *SEC v. Greenfield*, Civ. No. 5361, E.D. Pa., April 2, 1946.

147. *E.g.*, *Johnson v. Fuller*, 121 F.2d 618 (3d Cir. 1941) (no fraud at common law; violations of Securities Acts not alleged).

Such an exchange would constitute a "sale" of the new security, Securities Act § 2(3), but would be exempt from registration and prospectus requirements if no commissions were paid for soliciting the exchange, Securities Act § 3(a)(9); Securities Act Rule 149, 17 CODE FED. REGS. § 230.149 (1949); Securities Act Release No. 2029, Aug. 8, 1939. It would not, however, be exempt from the anti-fraud sections, Securities Act §§ 12(2) and 17(a); Exchange Act § 10(b).

148. BALLANTINE, CORPORATIONS § 298 (rev. ed. 1946). Merger of parent with subsidiary has been a common method of eliminating preferred stock dividend arrearages, and courts at common law will ordinarily not undertake to interfere unless the unfairness amounts to "bad faith" or "reckless indifference to the rights of others interested." *See, e.g.*, *Porges v. Vadsco Sales Corp.*, 32 A.2d 148, 151 (Del. Ch. 1943); BALLANTINE, *supra*, §§ 295-6; Dodd, *Accrued Dividends in Delaware Corporations—From Vested Right to Mirage*, 57 HARV. L. REV. 894 (1944); Dodd, *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942).

149. There is considerable doubt, however, whether the anti-fraud provisions of the Securities Acts can be applied to exchanges of securities in the process of merger, consolidation or sale of assets. The problem is whether or not such an exchange constitutes a "sale" of the new security (or "purchase" of the old security) by the corporation. Statutory language seems clearly to indicate that it would be: Securities Act § 2(3) defines "sale" to include "every contract of sale or disposition of . . . a security . . . for value. . . ." Exchange Act § 3(a)(13) defines "purchase" to include "any contract to buy, purchase, or otherwise acquire"; and "sale" is defined as "any contract to sell or otherwise dispose of." Exchange Act § 3(a)(14).

But the SEC, to its later regret, concluded that these exchanges were not "sales." Securities Act Release No. 493, Sept. 20, 1935 (note to Rule 5 of former Form E-1). Apparently, the only possible rationale for the result is that the element of individual choice is lacking in exchanges resulting from merger, consolidation, or sale of corporate assets. But, as the Commission later pointed out, "When a security holder is asked to vote in favor of a merger, consolidation, or certain reorganizations, he is being asked for his consent to accept a new security in exchange for the security he holds. Although the mechanism differs from that employed in the ordinary case in which one security is offered to the public in exchange for another, the net result is the same: the stockholder in effect is purchasing a new security and paying for it by turning in his old one." SEC, REPORT ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 24-5 (1941). Moreover, the dissenting shareholder can always get

defrauded when a corporation entices him to sell at an abnormally low price as when a corporate insider commits the offense. Nor is the loss any less objectionable when the consideration is an inferior security. Moreover, when a corporation retires its bonds or preferred stocks at an unjustifiable discount, or exchanges new bonds and/or stocks worth less than the real value of those bonds outstanding, it is in effect carrying out a reorganization without regard for the principle of full priority.<sup>150</sup> Finally, decisions of the corporation are in most cases the decisions of the insider.<sup>151</sup> And unless the corporation is held liable, the insider may use the corporation to make precisely the same profit, in the form of increased equity, which would be recoverable under Rule X-10B-5 if he had made the purchases himself—with the further advantage of not having to tie up his own funds.<sup>152</sup>

Thus, the corporation's duty to disclose should be as great as the insider's. It should include full disclosure of earnings, book value per share (or value of assets per bond), and in appropriate situations any important discrepancies between book value and actual value of assets. It should also include any unusual information, such as prospective sale of assets, having a material bearing on a security's worth. The corporation should disclose its identity as purchaser; and whenever business interests dictate non-disclosure of material facts, the corporation should be bound not to purchase. However, it is entitled to the same latitude given the insider in making general rather than individualized publication of facts concerning securities traded on a national exchange.<sup>153</sup>

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the appraisal value of his old shares. BALLANTINE, CORPORATIONS § 298 (rev. ed. 1946); in other words a choice, poor though it may be, is available.

The "no sale" theory was sustained without discussion in *National Supply Co. v. Leland Stanford Junior University*, 134 F.2d 689, 694 (9th Cir. 1943), *cert. denied*, 320 U.S. 773 (1943) (judgment for defendant in action under Securities Act § 12(1)), in which the SEC reluctantly filed a brief as *amicus curiae* in support of its note to Rule 5, *supra*. Since that time, the Commission has abolished Rule 5 without providing a written substitute of any kind.

The abolition of the rule would seem to have eliminated whatever warrant there earlier might have been for excluding from the fraud-provisions of the Acts exchanges of security of any kind.

150. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939); see *Northern Pacific Ry. v. Boyd*, 228 U.S. 482 (1913). See Note, 14 U. OF CHI. L. REV. 66, 70-1 (1946).

151. See, *e.g.*, *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947).

152. For example, assume the following hypothetical facts: (1) Corporation A has one class of securities currently selling at an aggregate price of \$1,000,000. (2) Insiders hold \$500,000 of the stock and the public holds the remaining \$500,000. (3) The real value of the stock is \$2,000,000. In this situation, the insiders may buy the public's stock for \$500,000, on which they will make a profit, in terms of equity, of \$500,000. On the other hand, the insiders may have the corporation buy the stock for \$500,000, thus reducing the value of the corporation's assets to \$1,500,000, but raising the value of the insider's stock from \$1,000,000 to \$1,500,000. In either case, the insider makes a \$500,000 profit.

153. See page 1149 *supra*.

In summary, effective application of Rule X-10B-5 requires that a corporation make full disclosure in connection with any purchase or exchange which the public security holder has an option to refuse. The plain effect of the rule would thus be to make it difficult if not impossible for corporations to effect a readjustment of capital structure for the purpose of benefiting certain groups or classes of stockholders—where the insiders usually will be found. Such “readjustments” are unfair no matter who is benefited.<sup>154</sup> They are particularly iniquitous when they are merely schemes by which insiders may use secret information to pad their wealth at the expense of the ordinary investor.

#### *Duty of Brokers and Dealers*

With respect to brokers and dealers, Rule X-10B-5 imposes requirements virtually parallel to those of Rule X-15C1-2.<sup>155</sup> The only important distinction is that the former covers in addition transactions in securities effected on national exchanges.<sup>156</sup>

A rather substantial body of doctrine has already been built up under Rule X-15C1-2, Rule X-10B-5 and Securities Act Section 17(a). The broker-dealer must disclose the market price of a security if his own quotation is not reasonably related to it: because of his position of supposed competence, he impliedly represents that any price he quotes is fair, and if it is not—and he fails to disclose market price—he is guilty of material misrepresentation.<sup>157</sup> An agent selling his own securities to his principal, or buying for his account from his principal-seller, must disclose to his customers his capacity, prevailing market price, and cost of securities to him—

154. For a refutation of various arguments presented in support of these “readjustments,” see Note, 14 U. OF CHI. L. REV. 66, 69-70 (1946).

155. See notes 55 and 56 *supra*.

156. Another difference between the two rules is that X-15C1-2 permits a “good faith” defense while X-10B-5 by its terms does not. Unless X-10B-5 has completely superseded the other rule, the “good faith” defense would have to be read into X-10B-5 in order to avoid anomalies similar to those presented in meshing § 10(b) with other liability provisions in the statutes. See pages 1135-40 *supra*. If the Commission wishes to guard against such a result, it can amend X-15C1-2 by eliminating the defense it wrote into its own rule in the first place.

157. *Charles Hughes & Co., v. SEC*, 139 F.2d 434, 436-7 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). This doctrine is popularly known as the “shingle” doctrine, *i.e.*, that a broker impliedly represents, when he hangs out his “shingle,” that he will deal fairly with his customers. It was originated by the SEC in *Matter of Duker and Duker*, 6 S.E.C. 386 (1939).

Market price is readily obtainable by the broker when the security involved is listed on a national exchange. For securities traded on the over-the-counter markets, “market price” means the best bid or asked quotation obtainable—in the exercise of “reasonable diligence”—from specialists. Exchange Act Release No. 4048, Feb. 20, 1948, pp. 7, 9, 19.

In 1942, the SEC circulated a proposed rule that market price be disclosed in every over-the-counter dealer transaction. Reception by the industry was cool, to say the least, and the proposal was dropped. Exchange Act Release No. 3940, April 2, 1947.

he cannot serve both his own and his customer's interests at the same time.<sup>158</sup> He cannot bounce securities from one customer's discretionary account to another, piling up commissions all the while.<sup>159</sup>

Beyond these commonplace requirements of fair dealing, there is some doubt as to how far the duty of a broker or dealer should go. The literal terms of X-15C1-2 require that a broker or dealer acting in any capacity in transactions over the counter must disclose any inside information that he knows or has reason to know. As a practical matter, however, he cannot get this information disseminated in dealings on a national exchange.<sup>160</sup> Moreover, there are further questions. Where a broker is acting as agent for an insider, must he disclose the name of the insider? Must he investigate whether or not the insider is riding on undisclosed information? The answer to the first question is probably "yes": the burden of getting his principal's name is negligible, if not non-existent, and the added check on abusive insider trading may be very useful. But a duty to investigate, even if not unfair, would be of little practical benefit to the public investor. An insider who has not disclosed secret information to begin with is not going to open his heart to his broker. In such circumstances, it may be impossible for the broker to get the information, and even if it were possible, the unearthing would be a time and money consuming enterprise.

#### *Duty Among Ordinary Investors*

The main reasons for imposing a high standard of behavior on insiders, on corporations, and on brokers and dealers do not apply to the public investor. By definition, the ordinary investor—if he really is an ordinary investor—has no first-hand sources of superior market information. In transactions among ordinary investors, therefore, it makes little sense to impose liability for failure to disclose a fact which a buyer or seller knew nothing about and probably couldn't even find out. Moreover, where transactions are in

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158. *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); and see Note, 57 *YALE L.J.* 1316 (1947), dealing with the SEC ruling which the court later affirmed.

159. *E.g.*, *Norris & Hirshberg Inc. v. SEC*, 177 F.2d 228 (D.C. Cir. 1949).

With respect to broker-dealer activities generally, a person is liable for any violations of statutory provisions or SEC rules committed by a broker or dealer under his control, unless he can show "good faith" and that he "did not directly or indirectly induce the act or acts constituting the violation or cause of action." Exchange Act § 20(a); *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 122 (W.D. Ark. 1949) (defendants held liable for permitting a correspondent broker-dealer to transact business for customers on an undisclosed basis through an omnibus account, and thus to misappropriate customers' funds).

On broker-dealer doctrines generally, see Loss, *The SEC and the Broker-Dealer*, 1 *VAND. L. REV.* 516 (1948).

160. These difficulties are comparable to those facing an insider. See page 1149 and notes 133-5 *supra*. As a matter of fact, the broker-dealer is in a more difficult situation, since he does not have available the avenues of corporate publicity available to the insider.

securities listed on an exchange or actively traded on the over-the-counter markets, it would be almost impossible either to require or enforce disclosure by the ordinary investor. And the SEC cannot be expected to dissipate its energies chasing down a multitude of disconnected two-party transactions, nor could Congress have intended it to do so.<sup>161</sup>

In short, while an X-10B-5 action is available against ordinary buyers or sellers, the rule probably imposes on defendants no higher duty of disclosure than that imposed by common law. That the ignorant may lose out to the shrewd is due largely to the fact that God did not create all men equal, a situation for which Congress and the Securities Acts have not supplied a remedy.

#### SUGGESTIONS AND SUMMARY

There should be two principal aims in protecting the public investor: to make it as difficult as possible for abuses to arise; and to make it as easy as possible for individuals to recover should damage be done.

Aside from close supervision of trading activities, the best method of meeting the first problem is to insure the fullest possible publication, at regular intervals, of all information concerning a corporation's worth. And in so far as possible, such information should be so framed that the ordinary investor can deduce what it means.<sup>162</sup> Regular publication of understandable reports would abort most opportunities for insider abuse at the outset.

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161. Typically, SEC proceedings under Rule X-10B-5 have involved cases in which the interests of a large number of investors were at stake. And even though an occasional proceeding against a broker or dealer, *e.g.*, to revoke registration, may have been based on an act which has damaged but few, the proceeding is designed to protect the many who might subsequently deal with the violator to their disadvantage; or it is designed to denominate as illegal a practice the status of which previously was in doubt. Like any administrative agency, the SEC must follow the principle of economizing in the use of limited resources.

162. It hardly need be pointed out that "adequacy" and "understandability" may be somewhat incompatible. It may be assumed that few public investors can understand the ordinary prospectus, let alone steel themselves to the task of reading it. Financial reports are little less abstruse.

This does not necessarily mean, however, that disclosure requirements have no effect. Professional traders fully understand the import of prospectuses and financial reports, and the impact of facts disclosed will be transmitted to the market by their trading activities. Moreover, a digest of disclosed information will seep down to the public via trade periodicals and investment services.

Shortly before the war, the SEC sought amendments to the Securities Act which would give it the power to deflate over-blown prospectuses, the issuer to be relieved of liability for materials excised by the Commission. It also requested authority to refuse acceleration of effective dates on unreasonably long registration statements. For a discussion of these proposed amendments, see Byse & Bradley, *Proposals to Amend the Registration and Prospectus Requirements of the Securities Act of 1933*, 96 U. OF PA. L. REV. 609 (1948); Lobell, *Revision of the Securities Act*, 48 COL. L. REV. 313 (1948). For hearings on these proposals, see *Hearings Before the House Committee on Interstate and Foreign Commerce on a Comparative Print Showing Proposed Changes in the Securities Act of 1933 and the Se-*

For this problem, Rule X-10B-5 at its best is not the answer. Though the rule may well require insiders and their corporations to publicize all material facts prior to engaging in securities transactions, failure of those parties to do so is discoverable, if at all, only after the violation has occurred. Thus the rule is a faulty preventive weapon.

It is of considerable importance, therefore, that Congress extend existing requirements for *regular* reports to corporations now exempt. Sections 12, 13 and 16 of the Exchange Act, and rules thereunder, are now restricted substantially to corporations having securities listed on a national exchange.<sup>163</sup> These requirements are even more essential for corporations whose securities are traded solely over the counter, for here the checks of active, open trading and readily determinable market price are largely absent. In fact, most of the impressive frauds of recent years have occurred in over-the-counter trading.<sup>164</sup> Proposed legislation currently before Congress would close much of this gap by extending report requirements of the Exchange Act to any corporation having \$3,000,000 or more in assets and 300 or more security holders.<sup>165</sup> This legislation should be passed. In addition, the SEC itself might help matters by enlarging the scope of required reports. A requirement that both cost and market value of inventory be reported, for example, might stop future *Transamerica* cases.<sup>165</sup>

To the second main aim of investor protection—making recovery easy—Rule X-10B-5 adds a great deal. It provides both buyers and sellers with causes of action which they do not have elsewhere—either at common law or under the Securities Acts—and with remedies against a broader range of culprits. Substantively, the rule imposes much more stringent duties on insiders, corporations, and brokers and dealers than ever existed before. In

*curities Exchange Act of 1934, etc.*, 77th Cong., 1st and 2d Sess. (1941-2), were terminated by the war. These proposed amendments might well be revived.

163. Much the same requirements apply to companies subject to the Holding Company and Investment Company Acts, regardless of whether or not their securities are listed on a national exchange. Holding Company Act § 14, 49 STAT. 827 (1935), 15 U.S.C. § 79n (1946); Investment Company Act § 8(c), 54 STAT. 804, 15 U.S.C. § 80a-8(c) (1946). And Exchange Act § 15(d) imposes the substance of § 13 report requirements on corporations which have registered under the Securities Act an issue valued at \$2,000,000 or more.

For a survey of the inadequacies of reports by corporations not subject to the Act, see PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES, H.R. DOC. NO. 672, 79th Cong., 2d Sess. 11-16, 37-74 (1946); SEC, REPORT ON A PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES 306, 14-44 (1950).

164. H.R. Doc. No. 672, *supra* note 163, at 5; SEC REPORT, *supra* note 163, at 9.

165. S. 2408, 81st Cong., 1st Sess. (1949); reprinted in *Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 2408*, 81st Cong., 2d Sess. 1 (1950). The Commission's proposed redraft appears *id.* at 50; the changes are indicated *id.* at 52.

166. Present requirements are outlined in SEC Reg. S-X, FORM & CONTENT OF FINANCIAL STATEMENTS, 17 CODE FED. REGS. § 210.5-02, Item 6 (1949), which specifies merely that it be indicated whether inventory is valued at "cost," "market," or "cost or market whichever is lower."

consequence, the defrauded plaintiff is much more likely to recover whenever it is financially possible—or worthwhile—for him to bring a private action.

While the instrument of a class action has increased the feasibility of private suits,<sup>167</sup> they still operate under serious financial handicaps. Yet here too Rule X-10B-5 has potentialities. Section 27 of the Exchange Act gives the federal courts jurisdiction over "all suits in equity and actions at law brought [by the Commission] to enforce any liability or duty created by this title or the rules and regulations thereunder."<sup>168</sup> No stretch of the statute would therefore be necessary for a court to hold that the SEC can bring an action to enforce restitution to the individuals defrauded of all damages resulting from a breach of Rule X-10B-5.

Other agencies, charged like the SEC with the duty of regulating business practices, have already been granted analogous powers by the courts.<sup>169</sup> Thus in *Porter v. Warner Holding Co.*,<sup>170</sup> the OPA Administrator was allowed to bring a suit for return of excess rents to tenants, despite the fact that the statute explicitly provided for private suits within a limited time only—which time had run—and further provided that after the deadline any funds

167. FED. R. CIV. P. 23(a) (3), permits the so-called "spurious" class action. See Purcell, Foster & Hill, *Enforcing the Accountability of Corporate Management and Related Activities of the SEC*, 32 VA. L. REV. 497, 517-22 (1946). Once the class action has been initiated, the statute of limitations is tolled for all members of the class who subsequently participate. *Deckert v. Independence Shares Corp.*, 39 F. Supp. 592, 597 (E.D. Pa. 1941), *rev'd on other grounds*, 123 F.2d 979 (3d Cir. 1941); 3 MOORE'S FEDERAL PRACTICE 3476 (1948). And the action cannot be dismissed or compromised without approval of the court. FED. R. CIV. P. 23 (c). While Rule 23(c) does not require the court to notify all members of the class affected by compromise of a spurious class action, the court may be under a duty to do so in the situation where defendants have "bought out" the named party-plaintiff. *Cf. Young v. Higbee Co.*, 324 U.S. 204 (1945).

168. 48 STAT. 902 (1934), as amended, 15 U.S.C. § 78aa (1946). This Section also authorizes a broad choice of forum (any district where the violation occurred, where the defendant is found, where he is an inhabitant, or where he transacts business) and permits nationwide service of process.

169. For example, the Wage-Hour Administration is empowered to supervise the payment of unpaid minimum wages or overtime compensation due an employee and to bring suit to recover such underpayments with the employee's consent. 52 STAT. 1069 (1938), as amended, 63 STAT. 919 (1949), 29 U.S.C.A. § 216(c) (Supp. 1949); SEN. REP. NO. 640, 81st Cong., 1st Sess. (1949); Note, 63 HARV. L. REV. 1078 (1950). At the time this legislation was pending and before its enactment, the second circuit decided, in *McComb v. Scerbo*, 177 F.2d 137 (2d Cir. 1949), that § 16(b) of the Fair Labor Standards Act authorizing employees to sue for unpaid overtime was not an exclusive remedy and that the administrator could obtain an order compelling an employer to pay unpaid overtime wages to employees, ancillary to injunctive relief restraining defendants from violations of the Wage-Hour law.

Similarly, the OPA administrator could bring actions to recover over-the-ceiling rent payments for benefit of the overcharged tenants. 56 STAT. 33 (1942), as amended, 50 U.S.C. App. § 925(a) (1946); *Porter v. Warner Holding Co.*, 328 U.S. 395 (1946).

170. 328 U.S. 395 (1946).

recovered by the Administrator were to go to the Government.<sup>171</sup> Since the Exchange Act contains no parallel detailed provisions, the SEC should *a fortiori* have power to bring actions for the benefit of defrauded investors. While the Commission would in most cases use the action only where a substantial number of victims are involved, it should also be able to bring any "test case" it thinks significant.

Should there be any doubt of the SEC's authority in this respect, however, Congress would do well to grant it by explicit amendment. An SEC civil action for damages under Rule X-10B-5 is necessary if a substantial number of defrauded investors are to be made whole.

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### A CORRECTION TO THE TEXTRON STORY

In Comment, *The Modern Philanthropic Foundation: A Critique and a Proposal*, 59 YALE L.J. 477 (1950), there appeared a brief discussion of the participation of several charitable trusts in the expansion of Textron Incorporated.

The primary purpose of this discussion was to illustrate how under existing tax laws the investment activities of charitable foundations can render considerable assistance to particular private businesses. An incidental purpose was to indicate a type of situation in which business and charitable purposes might conflict. In connection with this incidental question, it was suggested that there may have been such a conflict in the Textron situation.

It has been called to the attention of the JOURNAL that the sources relied on for this latter suggestion contained several statements which were incorrect, incomplete or misleading.\* After careful review, the JOURNAL feels that it is only fair to withdraw any inferences or conclusions suggesting abuse of discretion or breach of duty by any of the trustees mentioned in the Comment or by Textron directors or officers.

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171. Emergency Price Control Act, § 205(e), 56 STAT. 23, 33 (1942), 50 U.S.C. App. § 925(2) (1946). The Court rested its decision on § 205(a), which read in part: "upon a showing . . . a permanent or temporary injunction, restraining order, or *other order* shall be granted." (emphasis added). Restitution to tenants was legitimate, the Court said, either as an equitable adjunct to an injunction decree, or as an order necessary and appropriate to enforce compliance with the Act. 328 U.S. 395, 399-400 (1946). Justice Rutledge, joined by Justices Reed and Frankfurter, vigorously dissented on the ground that this interpretation flew in the face of the statute. *Id.* at 403.

\* Perhaps the most unfortunate example was as follows. The Senate Report stated that The Sixty Trust, on purchasing the Lonsdale Mills from the Rayon Foundation, renegotiated "the lease with Textron." This statement was incorrect. The lease was renegotiated with Lonsdale, the original lessee, which was at that time controlled by Textron. From this incorrect statement, the Comment incorrectly concluded that there was a "change in lessee." Because of this and other errors, footnote 117 on pages 494-5 of the Comment contained unwarranted inferences with respect to this transaction, particularly that "the change in lessee from Lonsdale to Textron was probably also designed to remove suspicion from the transaction."