IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket Nos. 30410 and 31157

CHARLES HEIT,

Plaintiff-Appellant,

v.

EDWARD H. WEITZEN, et al.,

Defendants-Appellees.

v.

BETTY VOLK,

Plaintiff-Appellant,

v.

EDWARD H. WEITZEN, et al.,

Defendants-Appellees.

v.

HELEN HOWARD,

Plaintiff-Appellant,

v.

STANLEY R. GRANT, et al.,

Defendants-Appellees.

APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF NEW YORK

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
AMICUS CURIAE

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
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STATEMENT OF THE CASE

The Securities and Exchange Commission files this brief in response to this Court's invitation of December 28, 1967, that it submit a brief *amicus curiae* on the issue relating to the

applicability of Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. 78j(b), and Rule 10b-5, 17 CFR 240.10b-5, promulgated by the Commission under that act.

The complaint in the Howard case alleges that defendant Belock Instrument Corporation ("Belock") "caused to be circulated and disseminated to the public-at-large through press releases, statements to the investment community, quarterly and other financial reports and through other media of communication to the public . . ." certain false and misleading financial statements and other information with respect to its contracts with the Government (¶¶ 11-12 (71a-72a)). 1/ The Heit complaint adds the allegation that some of these reports were filed with the Commission and with the American Stock Exchange, where Belock's common stock is listed (¶¶ 5-6 (17a)). 2/ It is alleged that earnings on the government contracts, which constituted over 90 per cent of Belock's sales, were overstated (¶ 5 (17a); ¶¶ 8, 12 (70a-72a)). The contracts included price redetermination clauses, and Belock allegedly had overcharged the Government through misallocations

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1/ The appendix to the brief of the plaintiffs-appellants is cited as "__a."

2/ Although there are some differences between the two complaints, which arise out of the same acts and transactions and are on behalf of basically the same class of investors, we assume that, insofar as one complaint contains allegations more favorable to the class than the other, leave to amend would be granted. Therefore, we shall discuss the legal issues involved in the context of the allegations from both complaints most favorable to the plaintiffs.

of costs among particular contracts (¶ 5 (17a); ¶¶ 9, 12 (70a-72a)).[3/]

According to the complaints the defendant officers, directors, controlling shareholders and auditors knew or should have known that the press releases and reports were false and misleading (¶ 7 (18a); ¶¶ 13-14, 20 (72a-74a)) and were responsible for the dissemination of these materials (¶ 5-6 (17a); ¶ 11 (71a)). In the Heit complaint it is alleged that these corporate statements were "intended to, and did, have the effect of artificially inflating the market prices of Belock's common stock and debentures" (¶ 8 (18a)). In the Howard complaint it is alleged that the corporate statements "served to raise or prevent the market prices from declining of the securities of Belock Instrument during the periods involved, as the defendants well knew and intended . . .," and that certain defendants "benefited therefrom" (¶ 15 (72a)).

Plaintiffs allegedly purchased Belock securities in reliance upon the false and misleading financial information (¶ 11 (18a)) and at artificially inflated prices (¶ 10 (18a); ¶ 18 (73a)). They brought these actions under Section 10(b) and Rule 10b-5 on behalf of themselves and all other persons who had purchased Belock securities under these circumstances (¶¶ 2, 11 (15a, 18a); ¶ 19 (73a)).[4/]

3/ As indicated by documents publicly filed with the Commission by Belock after discovery of the alleged fraud, it had two types of government contracts: contracts with a fixed price and contracts on an actual-cost-plus-fixed-fee basis. The Government has charged that Belock was allocating to the cost-plus contracts labor and general costs that should have been allocated to the fixed-price contracts and thus increased its profits on the fixed-price contracts by over $1,000,000 at the expense of the Government.

4/ Relief was also originally sought under other provisions of the securities acts and under the common law. Except for Section 18(a) of the 1934 Act, 15 U.S.C. 78r(a), these bases for relief have apparently been abandoned. Since the Court's invitation to the Commission was limited to the issue relating to the applicability of Section 10(b) and Rule 10b-5, we have not discussed Section 18(a) issues in this brief.

The district judges granted the defendants' motions to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure for failure to state a claim upon which relief could be granted. The principal ground for the dismissals was that the fraud complained of was not alleged to have been "in connection with the purchase or sale" of Belock securities because the defendants' purpose in making the allegedly false and misleading statements had been to defraud the Government rather than public investors, and because they had not engaged in any securities transactions themselves.

In the Howard case Judge Cooper cited the previous statement of this Court "'that section [10b] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs. . . .'" 5/ He determined that the complaint was "fatally defective for the allegations here do not show the gravamen of defendants' activities to be any wise 'in connection with the purchase or sale of any security. . . .'" He explained this conclusion, saying that "[w]hatever fraud is alleged here . . . is directed against the government, notwithstanding its possible incidental market impact. Furthermore, defendants or persons associated with them did not participate in the security transactions involved." 6/

5/ Birnbaum v. Newport Steel Corp., 193 F. 2d 461, 464, certiorari denied, 343 U.S. 956 (1952).

6/ Judge Cooper also stated that "the allegations of fraud are legally insufficient even under a liberal construction of the pleadings afforded to plaintiffs on a motion to dismiss" (footnote omitted). The Commission expresses no opinion on the procedural question under Rule 9(a) of the Federal Rules of Civil Procedure whether the plaintiffs have alleged fraud with sufficient "particularity."

In the Heit case Judge Sugarman analyzed the consolidated complaint in similar language and quoted from Judge Cooper's opinion. Although he conceded that the complaint did allege that the corporate publicity "'omit[ted] to state a material fact necessary in order to make the statements made . . . not misleading . . .'" within the meaning of Rule 10b-5, he concluded that the complaint was "devoid of the statement of any facts that the fraud complained of was perpetrated by the defendants 'in connection with any purchase or sale' of Belock's stock or debentures," because the public statements by the corporation were disseminated ". . . for the purpose of further defrauding the Government by not disclosing the original malfeasance and not for the purpose of perpetrating a 'misrepresentation or fraudulent practice usually associated with the purchase or sale of securities.'"

SUMMARY OF ARGUMENT

Transactions in widely held securities are continually taking place, and investors who engage in those transactions may be expected to rely upon whatever public statements are made by the corporations that issue the securities. For this reason the general antimanipulative and antifraud provisions of the Securities Exchange Act, Section 10(b) and Rule 10b-5, should be applied when those statements contain such false or misleading information about material aspects of the corporation's affairs that the market for its securities is likely to be affected.

Otherwise, the purpose of that act to bring about honest markets would be thwarted. For this reason, also, no distinction should be made between the situation in which the false statements are set forth in formal communications specifically directed to investors, such as reports to stockholders or documents filed with the Commission or stock exchanges, and the situation in which the false statements are contained in such informal communications as press releases to the general and financial news media. Nor, in determining whether the act has been violated, should there be any distinction based on the circumstance that those responsible for the misleading statements caused the dissemination of those statements for the specific purpose of affecting the market as against doing so for some other purpose that would have a similar effect on the market. In each instance, in view of the effect upon persons purchasing or selling the corporation's stock, the false statements must be considered to have been made "in connection with" those transactions within the meaning of Section 10(b) and Rule 10b-5. This interpretation of the statute will accomplish the legislative purpose without bringing every case of corporate mismanagement within the purview of the statute. And, although there may be troublesome problems of damages, they should not prevent the application of Section 10(b) and Rule 10b-5; the extent of damages may depend in part upon all the

circumstances under which the false statements were issued and, accordingly, should not be determined summarily on motion.

ARGUMENT

SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 ARE APPLICABLE TO THE FACTS ALLEGED IN THE COMPLAINT.

A. One of the Primary Purposes of the Securities Acts Is To Insure That Truthful Information About Securities, and Only Truthful Information, Is Available To Enable the Public To Make Informed Investment Decisions.

The Securities Exchange Act of 1934 was enacted "to insure the maintenance of fair and honest markets" 7/ for securities. Major provisions of this act, like the companion Securities Act of 1933 ("1933 Act") enacted by the same Congress, are designed to provide truthful information about securities for the investing public. In reporting favorably on the 1934 legislation the House Committee stated:

> "The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity . . . ." 8/

7/ Section 2, 15 U.S.C. 78b.

8/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11.

The Senate Committee stated in a similar vein:

> "It is universally conceded that adequate information as to the financial structure and condition of a corporation is indispensable to an intelligent determination of the quality of its securities. The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of an enlightened judgment as to what constitutes a fair price. Insofar as the judgment of either is warped by false, inaccurate, or incomplete information regarding the corporation, the market price fails to reflect the normal operation of the law of supply and demand. One of the prime concerns of the exchanges should be to make available to the public, honest, complete, and correct information regarding the securities listed." 9/

The Heit and Howard complaints allege, in effect, that the defendants have prevented the accomplishment of this primary objective with respect to the numerous investors who purchased Beleck securities on the basis of false and misleading information disseminated by the defendants throughout the marketplace. These investors now seek the aid of the courts in exercising their rights under the Securities Exchange Act to require those responsible for this state of affairs to make them whole for their loss. The district judges, however, placed the injured parties beyond the protection of this act merely because those who had polluted the marketplace had not themselves engaged in any securities transactions and intended to defraud the Government rather than injure public investors.

9/ S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), p. 68.

B. Congress Intended the Disclosure Provisions and the Antifraud Provisions of the Securities Acts To Operate as Complementary Elements of a Comprehensive Statutory Scheme To Carry Out the Legislative Purposes.

Requirements of disclosure and prohibitions of fraud were the complementary tools that Congress used in the two basic securities acts.[10/] The Securities Act of 1933 generally requires the disclosure of specified information that is to be formally filed with the Commission and distributed to prospective purchasers in connection with securities offerings. Although Congress did not consider this formal disclosure process to be necessary in every sale of securities,[11/] it did not want to leave completely unprotected any sales that fell within its constitutional powers. Thus, the general antifraud provision of the 1933 Act, Section 17(a), 15 U.S.C. 77q(a), applies to all sales of securities in which interstate means or the mails are used, whether or not exempt from the disclosure requirements of Section 5.[12/]

10/ Prior to 1933 the state blue sky laws were generally of two types: the so-called fraud statutes, which merely prohibited fraudulent practices in securities transactions, and the so-called registration or licensing statutes, which required affirmative disclosures of specified information before securities could be sold. Congress decided that neither of these techniques standing alone was sufficient to eliminate existing abuses, and it therefore used both of them in the securities acts.

11/ The registration and prospectus requirements are contained in Section 5, 15 U.S.C. 77e. Exemptions are contained in Sections 3 and 4, 15 U.S.C. 77c-77d.

12/ See Section 17(c), 15 U.S.C. 77q(c).

Even when securities are registered, the antifraud provision is necessary to prevent the frustration of the disclosure devices through other communications to prospective purchasers than the required registration statement and prospectus. Oral communications (other than by radio and television) and written communications accompanying or following the prospectus are also permitted. 13/ Thus, the disclosure provision itself does not preclude additional statements inconsistent with the required disclosures. The antifraud provisions were intended to fill this gap. The House Committee, referring to the fact that prospective purchasers of securities would be given information in addition to that contained in the prospectus, stated:

> "This additional information, of course, by virtue of the provisions contained in sections 12(2) and 16(a)(2) [ultimately 17(a)(2)] must not contain fraudulent statements or statements that are themselves untrue, either because of the misstatements that they contain or the facts of a relevant character that are omitted." 14/

13/ This is because Section 2(10), 15 U.S.C. 77b(10), excludes such communications from the definition of a prospectus.

14/ H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 13.

There are other gaps in the disclosure requirements for nonexempt sales. For example, the disclosure requirements are satisfied when a registration statement or prospectus is accurate as of its effective date. If subsequent events make continued use of the documents false or misleading, the Commission's only remedy is to initiate injunctive or criminal proceedings in the courts under the general antifraud provision. See, e.g., Danser v. United States, 281 F. 2d 492 (C.A. 1, 1960); Charles A. Howard, 1 S.E.C. 6, 10 (1934).

In the Securities Exchange Act of 1934 Congress repeated the legislative technique of combining complementary disclosure and anti-fraud provisions to achieve the underlying statutory purposes. The objectives of the 1934 Act are broader, however, than those of the 1933 Act. The latter act was primarily designed to protect investors in the purchase of securities, particularly in the course of primary distributions. The purpose of the 1934 Act, as stated in Section 2, was to regulate the securities markets in order "to insure the maintenance of fair and honest markets. . . ."

The regulatory requirements of each of these statutes are necessarily focused upon the statutory purposes. The obligations imposed by the Securities Act are keyed to the sale of securities, while the obligations imposed by the Securities Exchange Act depend upon the relationship of the conduct or transaction to the functioning of the securities markets. Thus, the statutory disclosure scheme for issuers in the Securities Act comes into play only when the issuer or its affiliates propose to sell securities. But the statutory disclosure scheme for issuers in the Securities Exchange Act is invoked simply because the issuers' securities are traded in the markets, originally upon exchanges and, since 1964, in the over-the-counter market as well. 15/

15/ Section 12 of the 1934 Act, 15 U.S.C. 78l, requires the registration of securities that are traded on a stock exchange and of certain other widely held securities. The information contained in the registration statement is required by Section 13, 15 U.S.C. 78m, to be kept "reasonably current" by periodic and other reports filed with the Commission and the stock exchanges "for the proper protection of investors and in order to insure fair dealing in the security." Officers, directors and major shareholders of (continued)

As with the 1933 Act, Congress in the 1934 Act did not consider the disclosure provisions alone sufficient to accomplish the statutory objectives. Thus, it included specific antifraud provisions such as in Section 9 of the 1934 Act, 15 U.S.C. 78i, which prohibits specified activities that would manipulate security prices, and Section 16(c), 15 U.S.C. 78p(c), which prohibits insiders from selling securities in their corporation "short" or "against the box." In addition to the specific antifraud provisions Congress also provided a general antifraud provision in Section 10(b), and the Commission has exercised its authority under that section to promulgate Rule 10b-5.

There is no reason to suppose that the same Congress that passed the 1933 Act intended the general antifraud provision of the 1934 Act to be any narrower in scope with regard to the overall purposes of that Act or to perform a different function in carrying out those purposes than it did with respect to the general antifraud provision of the 1933 Act. As stated in Section 2 of the 1934 Act, Congress intended "to impose requirements necessary to make . . . regulation and control [under the act] reasonably complete and effective." Certainly there was an equally great need under the 1934 Act for a provision both to prevent fraud in connection with securities transactions not covered by the disclosure provisions and to prevent the frustration of the formal disclosure requirements through voluntary communications

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15/ (continued)
corporations with securities registered under Section 12 are required by Section 16(a), 15 U.S.C. 78p(a), to file reports with the Commission and the stock exchanges as to their initial holdings of equity securities in those corporations and subsequent changes in those holdings. In addition, pursuant to Section 14 of the 1934 Act, 15 U.S.C. 78n, the Commission has promulgated specific requirements setting forth information to be sent to shareholders prior to their annual or other meetings. Schedules 14A-14C, 17 CFR 240.14a-101 to -103.

on the same subject matter. Indeed, Congress manifested its intention to use the general antifraud provision of the 1934 Act to protect the integrity of the formal disclosures that were required, as well as to prevent fraud when the disclosure provisions were not applicable, by stating in Section 10(b) itself that it applies to "any security registered on a national securities exchange and any security not so registered."[16/]

The legislative history of the 1934 Act indicates that Section 10(b) was intended to be as broad as the act itself. Congress recognized that the various existing abuses in the securities markets "were all a single seamless web."[17/] It also recognized that, just as the abuses themselves were all interrelated, the various provisions of the act designed to deal with particular abuses would have to be equally complementary. As the House Committee stated, "No one of these evils can be isolated for cure of itself alone."[18/] Section 10(b) was the provision that Congress intended to carry out this objective by filling any gaps left by the specific provisions. In describing Section 10(b) (as originally introduced) before the House Committee, Thomas G. Corcoran, one of the draftsmen of the act, noted that it provided in effect, "Thou shalt not devise any other cunning devices."[19/]

16/ When that act was originally adopted, the various disclosure provisions applied only to securities registered on a national securities exchange. Disclosure requirements as to other securities were added by the 1964 Securities Acts Amendments. See Section 12(g), 15 U.S.C. 78l(g)

17/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 6.

18/ Ibid.

19/ Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720, 73d Cong., 2d Sess. (1934), p. 115.

Representatives of the securities industry complained that this provision would give the Commission power to prohibit virtually anything,[20/] and the House then attempted to limit what is now Section 10.[21/] In conference, however, the Senate version, which then gave the Commission rulemaking power to prohibit "any manipulative or deceptive device or contrivance," S. 3420, § 10(b), 73d Cong., 2d Sess. (1934), was accepted by the House;[22/] and that version was enacted.

C. The Phrase "In Connection With the Purchase or Sale of Any Security," as Used in Section 10(b) and Rule 10b-5, Should Be Construed Broadly To Carry Out the Remedial Purposes of the 1934 Act and the Role of Its General Antifraud Provision in Achieving Those Purposes.

In dismissing the complaints in the instant cases the district judges relied upon the language of Section 10(b) and Rule 10b-5 limiting the application of those provisions to conduct "in connection with the purchase or sale of any security." The restrictive manner in which they construed this phrase is contrary both to the general

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20/ *Id.* at 178, 208-09, 251, 258, 297, 305; *Hearing Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.)*, 73d Cong., 1st and 2d Sess. (1933-1934), pp. 6624, 6634, 6899, 6910, 6936-6938, 6988.

21/ H.R. 9323, § 9, 73d Cong., 2d Sess. (1934).

22/ H.R. Rep. No. 1838, 73d Cong., 2d Sess. (1934), pp. 32-33.

principles that the Supreme Court has laid down for the interpretation of the federal securities laws and to specific holdings of a number of courts as to the meaning of this phrase.

The 1934 Act was intended to "be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes." Securities and Exchange Commission v. Capital Gains Bureau, 375 U.S. 180, 195 (1963) (footnote omitted). In Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), the Supreme Court referred to the "familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes" and, in reversing a narrow construction of the 1934 Act, stated that "the Securities Exchange Act quite clearly falls into the category of remedial legislation."

We have not been able to find any specific legislative history indicating the background for the inclusion of the "in connection with" phrase in Section 10(b). If no such phrase were in the section, however, Section 10(b) would be universally applicable and would authorize the Commission to promulgate rules and regulations prohibiting all kinds of manipulative or deceptive devices regardless of whether any securities transactions at all were involved. Since Congress did not intend the securities acts to be applicable to situations having no relation to securities transactions, it was thus necessary to insert language in both Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act so that these sections would not be broader than the intended scope

of the acts. This explains why Congress used the phrase "in the offer and sale of any securities" in Section 17(a) of the 1933 Act, which deals only with sales of securities, while it used the broader "in connection with" language in Section 10(b) of the 1934 Act, which provides for "regulation and control" of "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets" and of "practices and matters related thereto . . .," including the insurance of "the maintenance of fair and honest markets in such transactions . . . ." Section 10(b) does not say "in connection with the purchase or sale of any security by the alleged violator," and to read the underlined words into Section 10(b) is not only inconsistent with the statutory language but also with the statutory purpose of regulating the securities markets, which, as stated in Section 2, calls for the imposition of "requirements necessary to make such regulation and control reasonably complete and effective," whether or not the person whose conduct is sought to be controlled happens to be himself engaged in purchasing or selling securities at the time. As pointed out in Hooper v. Mountain States Sec. Corp., 282 F. 2d 195, 202 (C.A. 5, 1960), a primary purpose of the 1934 Act was "to keep the channels of interstate commerce, the mails, and national securities exchanges pure from fraudulent schemes, tricks, devices, and all forms of manipulation."

Unlike the decisions below, in Stockwell v. Reynolds & Co., 252 F. Supp. 215, 219 (S.D. N.Y., 1965), the phrase "in connection with" was construed "liberally in order to carry out the intent of the Act, which is designed to protect investors against fraud." It was there held sufficient that the fraud operates to prevent a securities transaction. In Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 978 (S.D. N.Y., 1964), Judge Feinberg described the phrase "in connection with" as a "broad" one that should be read in the light of "the intent of the Act and Rule to protect investors." H. L. Lee & Co. v. American Cardboard & Packaging Corp., 36 F.R.D. 27 (E.D. Pa., 1964), held that no consummated purchase or sale is necessary for a violation of Rule 10b-5. And in Meisel v. North Jersey Trust Co., 218 F. Supp. 274, 279 (S.D. N.Y., 1963), it was indicated that a violation of Section 10(b) and Rule 10b-5 would have been stated if the defendant broker, who had no direct dealings with the plaintiff, "knew that anything it did or said, or failed to do or say, would influence plaintiff to buy . . ." stock. The principle established by these decisions is that, when affirmative false or misleading statements have been made, such statements constitute a violation of Section 10(b) and Rule 10b-5 if the person who made them knew that his statements were likely to affect a securities transaction.

D. Neither the Motive for the Dissemination of False or Misleading Corporate Statements Likely to Affect the Market nor the Absence of Securities Transactions by Those Responsible for Their Dissemination Should Be Determinative of the Applicability of Section 10(b) and Rule 10b-5.

When the securities of a corporation are widely held, transactions in those securities are continually taking place in the open market. It was the existence of this market that created the need for the 1934 Act and caused Congress to provide in Section 13 of that act that corporations with securities listed on stock exchanges or widely held must file periodic reports about their affairs with the Commission and the exchanges. Since the purpose of the reporting requirements is to provide a constant flow of information about the corporation's securities so that investors will have a basis for informed investment decisions (see pp. 7-8, supra), it makes little sense to say that these reports are not disseminated "in connection with" all transactions in the securities of that corporation then taking place on the market. Since corporate reports sent directly to the shareholders are designed to serve the same purpose, even though they may not be required by the 1934 Act, the "connection" between their dissemination and the market is equally clear.

The same result is also apparent when corporate statements are made to the press about material aspects of a corporation's affairs through releases issued to the general and financial news media. The legislative history of the securities laws indicates that

Congress was concerned with insuring the truthfulness of publicly available information about securities. As we pointed out at p. 7, *supra*, the House Report on the 1934 Act states: "There cannot be honest markets without honest publicity."[23/]

Since a basic purpose of the general antifraud provisions of both securities acts is to prevent the circumvention and frustration of the formal disclosure requirements by false or misleading informal communications on the same subject matter (see pp. 10-13, *supra*), there is a close relationship between corporate reports filed under Section 13 or directly distributed to the shareholders under Section 14 and corporate press releases. It is our experience that corporations customarily issue press releases to the general and financial news media at the same time that they file reports with the Commission and the stock exchanges. It is these press releases and not the formal reports that receive the widest initial dissemination and are relied upon by numerous investors in making their investment decisions. If a corporation were free to say with impunity anything

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23/ In providing for express civil liabilities for misstatements under the 1933 Act, the House Committee had said that such statements, "because of their wide dissemination, determine the market price of the security, which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase. The connection between the statements made and the purchase of the security is clear, and, for this reason, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements." H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 10.

it pleased in such press releases, so long as the reports filed with the Commission were accurate, the reporting requirements would, to use the words of this Court, be "little more than a snare and a delusion." Charles Hughes & Co. v. Securities and Exchange Commission, 139 F. 2d 434, 438 (1943), certiorari denied, 321 U.S. 786 (1944). Unless this can be prevented by Section 10(b), the "reasonably complete and effective" regulation called for by Section 2 of the Act could not be obtained.

A flagrant example of the need for the application of Section 10(b) and Rule 10b-5 to deal with inconsistent corporate statements occurred in the Electrogen Industries case, in which the Commission recently obtained a preliminary injunction.[24/] The Commission had suspended trading in the defendant corporation's securities pending clarification of apparently false information that was being widely disseminated about the corporation's principal product. After negotiations with the Commission the defendant corporation mailed a statement to its stockholders denying the false information and furnishing accurate information about the corporation's affairs. The Commission then lifted the trading ban.

24/ Securities and Exchange Commission v. Electrogen Indus., Inc., 68 Civ. 23 (E.D. N.Y., Feb. 26, 1968) (not yet reported).

Immediately thereafter persons associated with the corporation held press conferences repeating the same false information that had caused the Commission to suspend trading. Since there had been no violation of any disclosure provisions, and the prior experience suggested that the temporary suspension of trading was not a permanent cure, the Commission sought an injunction under Section 10(b) and Rule 10b-5 to prevent further false or misleading publicity about this corporation.

The Electrogen Industries case also points out the relationship between the general antifraud provisions of the 1934 Act and other provisions designed to secure adequate disclosures. The Commission is specifically authorized by that act to suspend trading in securities, both on the exchanges and in over-the-counter markets when "in its opinion the public interest and the protection of investors so require." 25/ Such suspensions are designed "to prevent fraud," immediate action being necessary "when fraudulent or manipulative practices of the issuer or other persons have deprived . . . [a] security of a fair and orderly market, or when some corporate event has made informed trading impossible and has created conditions in which investors are likely to be deceived." 26/ The situation alleged in the complaints

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25/ See Section 15(c)(5), 15 U.S.C. 78o(c)(5) (over-the-counter). Section 19(a)(4), 15 U.S.C. 78s(4), which deals with suspensions of trading on exchanges, uses only the "public interest" language.

26/ S. Rep. No. 379, 88th Cong., 1st Sess. (1963), pp. 26, 66.

in the instant cases falls within this description; and, in fact, the Commission did suspend trading in Belock securities on June 22, 1965, after its staff had been advised "that, on the basis of information so far developed, there have been substantial overcharges in certain Government contracts which will have a mterial [sic] adverse effect on the financial condition of the company as well as on its published prior earnings reports."27/ The trading ban was lifted in November 1965 "in view of . . . [subsequent filings and other] disclosures by the company."28/

The suspension device was intended to act only as a stop-gap measure to afford a breathing period until adequate disclosures could be made; Congress did not intend the Commission to keep suspensions of trading in effect indefinitely.29/ If such disclosures cannot be obtained during a suspension period of reasonable duration, or if, as in the Electrogén Industries case, the same false information is again disseminated to the public after the suspension has been lifted, the only other alternative for the Commission is to commence an enforcement action under Section 10(b) and Rule 10b-5.

27/ Securities Exchange Act Release No. 7632 (June 22, 1965).

28/ Securities Exchange Act Release No. 7741 (November 4, 1965).

29/ S. Rep. No. 379, 88th Cong., 1st Sess. (1963), pp. 25-26, 66-67.

One of the reasons given by the judges below for holding Section 10(b) and Rule 10b-5 inapplicable here was that the defendants publicly disseminated false or misleading information for the purpose of defrauding the Government and not to injure investors. Although there is some question whether the district judges properly read the pertinent allegations of these complaints (see p. 3, *supra*), we believe that their holding that Section 10(b) and Rule 10b-5 are applicable only when false or fraudulent statements are motivated by a desire to defraud investors is unwarranted. Even at common law it had long been established that one who knowingly disseminated false statements could not escape liability for his actions on the theory that he did not intend to defraud the particular persons who were injured.30/ In fact, congressional dissatisfaction

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30/ See, *e.g.*, *Claflen* v. *Commonwealth Ins. Co.*, 110 U.S. 81, 96-97 (1884). As Justice Holmes said in *Ellis* v. *United States*, 206 U.S. 246, 257 (1907): "If a man intentionally adopts certain conduct in certain circumstances known to him, and that conduct is forbidden by the law under those circumstances he intentionally breaches the law in the only sense in which the law ever considers intent."

To suggest, as did the judges below, that the statement was "directed against the government" (see p. 4, *supra*) is comparable to urging that the cry "fire" in a crowded theater was directed at the person in Row A, Seat 3. Moreover, it should be noted that the reports in question were not filed with the Department of Defense, with which Belock did its contract business, but with the Securities and Exchange Commission and the American Stock Exchange.

with rules of the New York Stock Exchange that made the unlawfulness of stock pools turn on proof of motive was one of the bases for legislation in 1934. As the Senate Committee stated, "Motive furnishes no justification for the employment of manipulative devices."[31/] It is difficult to believe that the same Congress that considered these stock exchange rules to have been "emasculated by the inclusion of restrictive phraseology"[32/] would have intended its own legislation to be read in an equally restrictive manner. The fact that defendants' motive for publicly disseminating false and misleading corporate statements may not have been to defraud investors but to defraud the Government is small comfort to investors who may have been injured as a result of the defendants' misconduct. As stated in Puharich v. Borders Electronics Co., CCH Fed. Sec. L. Rep. ¶ 92,141, at 96,653 (S.D. N.Y., Jan. 24, 1968): "The injury to the

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31/ S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), p. 32.

32/ Id. at 49.

. . . [investors] is the same, no matter what . . . [the defendants'] motive."

The only limitation to the applicability of the general antifraud provisions other than the "in connection with" phrase is that interstate means or the mails must be used. This requirement is met when use of such means by other persons is reasonably foreseeable, despite the fact that the use of these means is neither requested nor desired by the wrongdoer. 33/ The likelihood that securities transactions by other persons will be affected by false statements should be equally sufficient to meet the "in connection with" limitation irrespective of any desire on the part of the wrongdoer to affect such transactions.

The judges below also held that the complaints in the instant cases were deficient because they did not allege that the defendants themselves had engaged in transactions in Belock securities. This result would have been justified under the antifraud provisions of the Securities Act of 1933, since in general that act imposes obligations only upon those persons actually selling securities or assisting in the sales. The 1934 Act is different. It deals with all matters affecting the securities markets. And many provisions of that act impose obligations upon persons whether or not they are engaged in

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33/ See, e.g., McDaniel v. United States, 343 F. 2d 785 (C.A. 5), certiorari denied, 382 U.S. 826 (1965); Danser v. United States, supra, 281 F. 2d 492; Creswell-Keith, Inc. v. Willingham, 264 F. 2d 76 (C.A. 8, 1959); cf. Pereira v. United States, 347 U.S. 1, 8-9 (1959).

securities transactions; for example, the presence or absence of securities transactions by the corporation or its insiders does not affect the registration obligations under Section 12, the reporting obligations under Section 13 or the obligations under Section 14 to distribute information to shareholders prior to their meetings (see pp. 11-12 n.15, *supra*).

Furthermore, this Court has afforded relief under Section 10(b) and Rule 10b-5 even when the defendants have not engaged in securities transactions with the plaintiff. *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F. 2d 540 (1967); *cf.* *Vine* v. *Beneficial Fin. Co.*, 374 F. 2d 627, *certiorari denied*, 389 U.S. __ (1967). As the Court said in the *Mutual Shares* case, the requirement of privity "has more recently been ignored." 384 F. 2d at 543-544. And another court has stated, *Bredehoeft* v. *Cornell*, 260 F. Supp. 557, 559 (D. Ore., 1966), "Section 10(b) does not require that if the plaintiff [victim] is a seller of a security that the defendant [wrongdoer] must be the purchaser. It only requires wrongdoing in connection with the purchase *or* sale of a security." Indeed, the defendants here have not attempted to rely upon the apparent holdings of the judges below that the complaints are defective because of a lack of privity. If there need be no transaction with the plaintiff, there is no reason why the availability of relief should turn upon the fortuitous circumstance that the defendant did or did not have securities transactions with third persons, which transactions in most instances would be irrelevant both to the fraudulent conduct complained of and to the injuries

suffered by particular plaintiffs as a result.

There may be circumstances of complete nondisclosure in which the applicability of Section 10(b) and Rule 10b-5 turns on whether the alleged wrongdoer has been trading in securities, as when there are legitimate corporate reasons for keeping news secret. For example, in the Texas Gulf Sulphur case[34/] the Commission did not contend that the corporation had violated Section 10(b) and Rule 10b-5 because it failed to disclose that it had discovered a large mineral deposit while it was purchasing the surrounding land. It contended only that at that time these provisions were being violated by the corporate officials and employees who were purchasing its securities on the basis of this secret information. This is because it is the securities transaction itself that gives rise to the duty to disclose in such situations. But, when there has been widespread dissemination of affirmatively false or misleading corporate statements that necessarily affect securities transactions then taking place on the market, the applicability of Section 10(b) and Rule 10b-5 should not depend upon whether there has also been trading by the corporation or its insiders.

Realistically, corporate executives commonly have a substantial interest in the market for their corporation's securities regardless of whether they are engaging in any transactions at the time. Insofar as they may previously have received stock options as additional compensation,

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34/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., pending in this Court (Docket No. 30882).

the value of those options depends upon future rises in the market price of the stock, and they have an incentive to issue favorable publicity in order to encourage such price rises. In addition, shareholders may judge the performance of management as much by the price of the corporation's stock as by its earnings reports, and management thus has a further personal interest in the market. In our view, denying the investing public the protection of Section 10(b) and Rule 10b-5, when a corporation has issued false statements, on the theory that the corporation and its insiders are not actually engaging in securities transactions is an artificial distinction neither required by the language of those provisions nor consistent with the remedial legislative purposes.

It has been stated that, if Section 10(b) and Rule 10b-5 were inapplicable because a corporation that publicly disseminated false and misleading information about its affairs was not engaging in securities transactions with the public at that time, the law, in effect,

> ". . . would allow a corporation whose stock is issued publicly to make misrepresentations concerning the stock without any fear of liability as long as its stock was only sold to the public in the market by underwriters or others. Such a rule would ignore the realities of the public securities market, and such was certainly not the intention of Congress."

Freed v. Szabo Food Serv., Inc., CCH Fed. Sec. L. Rep. ¶ 91,317, at 94,363-5 (N.D. Ill., Jan. 14, 1964).

This unwarranted result would also severely hamper the Commission in its enforcement activities. For example, in the Electrogen Industries case (see pp. 20-23, supra), the Commission did not have any evidence of securities transactions by the defendants at the time it commenced its action. It was only fortuitous that during the trial the Commission obtained evidence of an incidental securities transaction by one of the defendants. But only by going to court immediately to attempt to stop the dissemination of false publicity that was having a serious detrimental effect on the market could the Commission adequately protect the investing public. Judge Dooling stated in his opinion that in such a situation, when "the SEC, in a sense, acts for all potential sellers and buyers as a class, no more need be shown (beyond jurisdictional facts) than the defendants' responsibility for the false statements, the defendants' knowledge that the statements will influence the making of security transactions, and the falseness of the statements."[35/]

Although our position with respect to the applicability of Section 10(b) and Rule 10b-5, as expressed in our briefs to this Court in the Great American Industries case[36/] and in the Texas Gulf Sulphur case, was previously stated in the context of enforcement actions by the Commission, we believe that no different result would be appropriate in private

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35/ Accord, Fleischer "Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding," 51 Va. L. Rev. 1271, 1292-1295 (1965).

36/ Securities and Exchange Commission v. Great Amer. Indus., Inc. (Docket No. 31010).

actions for damages. The Supreme Court has pointed out that private rights of action are "a necessary supplement" to the Commission's own enforcement activities, J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964); and this Court has made it clear that private rights of action for damages are to be implied under Section 10(b) and Rule 10b-5.[37/] Although private parties may be required to prove additional elements to recover damages for such violations that are not required in Commission enforcement actions,[38/] we believe that Section 10(b) and Rule 10b-5 are applicable in both contexts to false or misleading corporate statements likely to affect the market.

E. Issues as to the Damages That May Be Recovered in a Private Action Under Section 10(b) and Rule 10b-5 Should Not Be Summarily Resolved Before the Facts of the Case Have Been Fully Developed at the Trial.

The defendants-appellees are still pressing in this Court their motion for summary judgment based on the claim that the plaintiffs have suffered no damages.[39/] This motion was not decided by the court below. Neither this particular issue of damages nor other issues that have been raised[40/] with respect to the scope of the monetary liabilities for a violation of

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37/ See, e.g., Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (C.A. 2, 1951).

38/ Compare, e.g., H. Sims Organ & Co. v. Securities and Exchange Commission, 293 F. 2d 78, 80 n.3 (C.A. 2, 1961), certiorari denied, 368 U.S. 968 (1962), with List v. Fashion Park, Inc., 340 F. 2d 457 (C.A. 2), certiorari denied, 382 U.S. 811 (1965). See generally, Securities and Exchange Commission v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 277-278 (S.D. N.Y., 1966).

39/ Brief for defendants-appellees Edward H. Weitzen, et al., pp. 34-39.

40/ Id. at 23-25.

Section 10(b) and Rule 10b-5 in circumstances such as this should be resolved, in our view, on a motion to dismiss the complaint or for summary judgment.

The Commission recognizes that the application of Section 10(b) and Rule 10b-5 to activities affecting large numbers of investors, rather than only specific individuals, and the private rights of action that this Court and other courts have held to flow from the violation of these provisions raise important questions with regard to the extent of the monetary liabilities that could result. As an agency that has devoted many years of effort to increasing the flow of accurate and meaningful information about securities and otherwise protecting public shareholders, the Commission would be the last to suggest that the courts should impose liabilities that might actually interfere with these important objectives.

The Commission believes, however, that any problems that arise with respect to the extent of monetary liabilities can and should be dealt with in that specific context. It is not necessary in order to meet these problems to hold that the statute and rule are completely inapplicable, with the result that the Commission's enforcement power with respect to the dissemination of deceptive and misleading information in the market would be seriously impaired. Nor is it necessary to eliminate in this area private rights of action, which, as the Supreme Court has pointed out, are "a necessary supplement" to Commission enforcement. J. I. Case Co. v. Borak, supra, 377 U.S. at 432.

Consequently, when, as in these cases, a member of the investing public has alleged that by reason of a serious violation of Section 10(b) and Rule 10b-5 he has suffered significant injury, we believe that he is entitled to his day in court, and that his complaint should not be summarily dismissed. On the other hand, it may well be premature to endeavor to determine at this stage the extent of the monetary liability that might result if the plaintiffs are successful in proving their allegations. This should properly await the trial of the case, which will provide a complete record as to exactly what the defendants did, why they did it and how this affected the plaintiffs. We believe the Court will then be in a better position to examine and resolve questions with respect to the appropriate remedy, giving consideration to how a damage award against the issuer would affect the issuer and all of its stockholders, including those who neither bought nor sold. In so doing the Court will be able to utilize its traditional flexibility with respect to remedies, avoiding, on the one hand, Draconian relief and, on the other hand, an opportunity for violators to profit from their wrongdoing.

Although the Commission recognizes that the determination of an appropriate remedy and, indeed, the existence and scope of implied private rights of action are questions for the courts, it nevertheless recognizes the importance of these issues and intends to give them most careful consideration. As a result of that consideration, the Commission believes that it will be in a better position to assist this Court or other courts in applying traditional damage principles or developing new ones in a manner best adapted to accomplishing the underlying purposes of the federal securities laws.

F. The Fact That Affirmatively False or Misleading Corporate Statements Likely To Affect the Securities Markets May Be Part of a Larger Scheme of Corporate Mismanagement Cannot Give Immunity From Section 10(b) and Rule 10b-5.

Both judges below relied on the statement of this Court in the Birnbaum case, supra, 193 F. 2d at 464, that Section 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the purchase or sale of securities rather than at fraudulent mismanagement of corporate affairs." This Court has recently indicated that the Birnbaum language does not mean that it is "sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the purchase or sale of securities.'" A. T. Brod & Co. v. Perlow, 375 F. 2d 393, 397 (1967).41/ This is not to say that Section 10(b) and Rule 10b-5 are "a mandate to inquire into every allegation of breach of fiduciary duty respecting the issuance or sale of corporate securities." O'Neill v. Maytag, 339 F. 2d 764, 768 (C.A. 2, 1964).42/ But the O'Neill case and other cases involving the "corporate management" issue deal only with the question whether proof of deception is required under Section 10(b) and Rule 10b-5. They do not hold that,

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41/ The Court went on to state that "[w]e believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." 375 F. 2d at 397.

42/ Contra, Dasho v. Susquehanna Corp., 380 F. 2d 262 (C.A. 7), certiorari denied, 389 U.S. 977 (1967); but cf. Ruckle v. Roto-American Corp., 339 F. 2d 24 (C.A. 2, 1964).

when deception is present, the fact that this deception occurred as part of a larger scheme of corporate mismanagement confers any immunity upon those responsible. As stated in O'Neill, "There is, of course, no reason why the acts of an agent or corporate officer may not violate both his common law duty and the duty imposed by Rule 10b-5." 339 F. 2d at 768.

There can be no question that these cases involve deception within the meaning of the O'Neill decision. The complaints allege misstatements of material facts in Belock's 1964 annual report[43/] and in other documents that it issued to the press and to its shareholders (17a, 71a-72a).

The allegations now before the Court do not involve the troublesome problem of determining when and under what circumstances an act of corporate mismanagement may be converted into a violation of Section 10(b) and Rule 10b-5 by implying an obligation to come forward with disclosure of such mismanagement and then holding that a failure to make the disclosure is a violation of those provisions. The existence of an affirmative obligation to come forward with disclosure under such

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43/ For example, Note 13 to the financial statements in the annual report in question reads as follows: "A substantial portion of the Company's sales is subject to renegotiation. Renegotiation proceedings for the fiscal years through October 31, 1963 have been completed. No provision for refunds for 1964 has been made or is believed necessary." This report is in the Commission's Public File No. 1-3882-2-3.

circumstances rather than remaining silent may depend upon a number of factors. These include (1) the nature of the relationship between the person allegedly under such a duty and either the issuer or the person alleging injury,[44/] (2) whether that person was trading in the securities markets on the basis of the allegedly undisclosed information[45/] and (3) the nature and materiality of the information. In the instant cases it is not necessary to determine whether the defendants were required by Section 10(b) and Rule 10b-5 to come forward and disclose their transactions with the Government in a situation in which they were entitled, and would have preferred, to remain silent. Here we have the dissemination of affirmatively false and misleading information, both voluntarily and in response to a statutory disclosure scheme. When this occurs and when the securities markets may thereby be affected, Section 10(b) and Rule 10b-5 are clearly violated; and there is no occasion to consider what duties of affirmative disclosure may be implied.

44/ An affirmative duty of disclosure may be imposed upon corporate insiders or other persons having a fiduciary or other special relationship to the plaintiff where it may not be imposed upon strangers dealing at arm's length in the market.

45/ Thus, in the Texas Gulf Sulphur case we contended that corporate insiders could not trade upon material undisclosed information, but we did not contend that the corporation, which had not traded, had an affirmative duty to come forward with disclosure prior to the time that it first chose to issue a press release about its exploration program (see p. 27, supra).

Defendants contend that most acts of corporate misconduct will have an impact upon the financial statements of the corporation, and failure to disclose such acts may thus be regarded as an omission of a fact necessary to make the financial statements not misleading.[46] Properly prepared financial statements of a corporation, to the extent that the limitations of accounting permit, reflect all developments in its affairs that determine or affect the amount of its assets or earnings. Since financial statements of a corporation that fail to reflect important developments in its affairs relating to its assets or earnings may be inaccurate or misleading, their publication may constitute a violation of Section 10(b) and Rule 10b-5. If these provisions are violated because of failure to reflect material events in the financial statements, certainly the fact that these events involve corporate misconduct rather than other business developments should not preclude application of the statute and rule. Some important criminal cases in this circuit under the securities acts have involved either the failure to file required reports or the filing or dissemination of reports that were false and misleading, in both instances for the purpose of concealing misconduct amounting to corporate mismanagement, including schemes to defraud the Government by evading income taxes.[47]

46/ Brief for defendant-appellee Tyminski, pp. 11-12; brief for defendants-appellees Weitzen, *et al.*, pp. 13-15 & 14n., 23-25.

47/ *E.g.*, *United States* v. *Guterma*, 281 F. 2d 742, 746 (C.A. 2), *certiorari denied*, 364 U.S. 871 (1960); *United States* v. *Pope*, 189 F. Supp. 12, 24-25 (S.D. N.Y., 1960); *United States* v. *Schluter* (S.D. N.Y.), Litigation Release Nos. 973 (Apr. 16, 1956), 1075 (Feb. 27, 1957), 1083 (Mar. 26, 1957); *cf. Londontown Mfg. Co.*, 41 S.E.C. 676 (1963).

The Commission's position in short can be stated in the language of this Court (see pp. 33-34 & n.41, supra) that Section 10(b) and Rule 10b-5 were intended to protect the investing public from all false or misleading statements that are likely to affect securities transactions, whether such statements are the kind "usually associated with the purchase or sale of securities," whether they "present a unique form of deception" or whether they involve "acts of an agent or corporate officer . . . [that] violate both his common law duty and the duty imposed by Rule 10b-5."

CONCLUSION

For the reasons stated above, the Commission believes that Section 10(b) and Rule 10b-5 are applicable to the misconduct alleged in the complaints in these cases.

Respectfully submitted,

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