No. 79-66

In the Supreme Court of the United States

OCTOBER TERM, 1978

PETER E. AARON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-29a) is not yet officially reported. The opinion of the district court (Pet. App. 30a-50a) is not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1979. On June 11, 1979, Mr. Justice Marshall extended the time to file a petition for a writ of certiorari to and including July 10, 1979, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), requires proof of *scienter* in an injunctive proceeding brought by the Securities and Exchange Commission.

2. Whether Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, require proof of *scienter* in an injunctive proceeding brought by the Securities and Exchange Commission.

STATEMENT

In February 1976 the Securities and Exchange Commission filed a complaint in the United States District Court for the Southern District of New York against eight defendants, including petitioner,[1] alleging violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5, in connection with the offer and sale of common stock of Lawn-A-Mat Chemical & Equipment Corp. ("Lawn-A-Mat") (Pet. App. 31a).[2] Petitioner had

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[1]Each defendant except petitioner consented to the entry of a permanent injunction (Pet. App. 31a).

[2]The complaint also charged petitioner and three other defendants with violations of registration provisions of the federal securities laws, Section 5(a) and (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and (c) (Pet. App. 31a). The district court found that petitioner had violated the registration provisions and enjoined him from future violations (Pet. App. 40a-44a). The court of appeals affirmed this disposition, noting that petitioner had arranged a sham transaction in order to create the appearance of an exemption from the registration provisions (Pet. App. 10a-13a, 21a). Petitioner does not raise in his petition any question concerning the judgment insofar as it enjoins him from future violations of the registration provisions.

supervisory responsibility over the employees of a broker-dealer firm registered with the Commission (Pet. App. 32a-33a).[3] The complaint alleged that petitioner violated and aided and abetted violations of the antifraud provisions in that he knew or should have known that employees of the broker-dealer firm were making materially false and misleading representations in the offer and sale of Lawn-A-Mat stock, but he failed to take steps to prevent or terminate the fraudulent activity (J.A. 3, 8-12).[4] Following a three-day evidentiary hearing, the district court found that petitioner had violated Section 17(a), Section 10(b), and Rule 10b-5, and enjoined him from future violations of those provisions (Pet. App. 31a, 45a).

The court of appeals affirmed (Pet. App. 21a). Addressing Section 10(b) and Rule 10b-5, the court rejected petitioner's contention that *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976)—which held that *scienter* is a necessary element of a private damage action under those provisions—compels the conclusion that *scienter* is also a necessary element in a Commission injunctive proceeding. Concluding that proof of *scienter* is not required in such a proceeding, the court of appeals found it "unnecessary to reach the question whether [petitioner's] conduct would support a finding of scienter * * *" (Pet. App. 13a).[5]

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[3]Petitioner does not challenge the findings of the court of appeals and the district court (Pet. App. 4a, 8a, 33a) that he had managerial and supervisory responsibility over the firm's activities and employees.

[4]"J.A." refers to the joint appendix in the court of appeals.

[5]The district court had found that petitioner's misconduct was "sufficient to establish his scienter * * *" (Pet. App. 13a, 40a).

In declining to adopt a *scienter* requirement for Commission injunctive proceedings brought under Section 10(b) and Rule 10b-5, the court of appeals analyzed the factors considered by this Court in the context of private damage litigation in *Hochfelder*—the language of Section 10(b), the legislative history of the Securities Exchange Act, the relationship between Section 10(b) and the express private remedy provisions of the securities laws, and the effect of a *scienter* standard on the overall enforcement scheme contemplated by the securities laws. Noting that "different courts have construed the language [of Section 10(b)] differently," the court concluded that the language of the section alone was not dispositive of the issue (Pet. App. 16a). The court also concluded that the legislative history of the Securities Exchange Act shows that Congress did not intend to require *scienter* in Commission injunctive suits (Pet. App. 17a-18a). Finally, the court found rejection of a *scienter* requirement to be consistent with the statutory enforcement scheme (Pet. App. 18a). In this regard the court observed that, unlike the situation in *Hochfelder*, no provisions of the federal securities laws would be "nullified" by permitting Commission injunctive proceedings predicated on a showing of negligence[6] and that a negligence standard in such proceedings would harmonize Section 10(b) with "similar prophylactic provisions" of the Securities Act of 1933 (Pet. App. 19a). Apart from its analysis of

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[6]In *Hochfelder*, this Court noted that the statutory provisions expressly allowing private recovery for negligent conduct, Sections 11, 12(2), and 15 of the Securities Act of 1933, 15 U.S.C. 77k, 77l(2), and 77o, are "subject to significant procedural restrictions not applicable under [Section] 10(b)." 425 U.S. at 209-210. An extension of the remedies under Section 10(b) to actions premised on negligent wrongdoing, the Court concluded, would "nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." 425 U.S. at 210.

Hochfelder, the court of appeals reaffirmed the view, expressed in its prior decisions, that in light of the essential purpose of injunctive relief—"to protect the public against harm, not to punish the offender" (Pet. App. 16a, quoting *SEC* v. *Coven*, 581 F. 2d 1020, 1027-1028 (2d Cir. 1978), cert. denied, No. 78-956 (Mar. 5, 1979))—the increased protection to investors resulting from a negligence standard in government injunctive proceedings outweighed any potential harm to those enjoined for their negligence (Pet. App. 15a).

The court of appeals also rejected a *scienter* requirement for Commission injunctive proceedings brought under Section 17(a), relying on its prior decision in *SEC* v. *Coven*, *supra* (Pet. App. 19a). In *Coven*, the court of appeals observed that Section 17(a) does not contain any language comparable to the phrase "manipulative or deceptive device or contrivance" in Section 10(b) and that there is thus no reason to give the provision a "narrow reading." 581 F. 2d at 1026-1027. The *Coven* court also noted that the legislative history of Section 17(a) indicates that Congress had considered a *scienter* requirement but "opted for liability without willfulness, intent to defraud, or the like, in enacting §17(a)." *Id.* at 1027.

DISCUSSION

The court of appeals correctly determined that proof of *scienter* is not required in a Commission injunctive proceeding brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder or under Section 17(a) of the Securities Act. Nevertheless, in view of the importance of these issues to the administration of the federal securities laws, the extraordinary amount of time expended in litigating these issues, and the disagreement among the lower courts concerning the need to prove *scienter* in Commission injunctive proceedings, the Commission believes that the Court should grant the petition for a writ of certiorari in this case.

1. The issues raised by petitioner—whether the Commission is required to prove *scienter* on the part of a defendant in an action seeking injunctive relief against future violations of Section 10(b) or Section 17(a)—are important. The imposition of a *scienter* requirement in all Commission proceedings brought to prevent recurrence of conduct that operates as a fraud or deceit on public investors, and the resulting difficulty in proving a defendant's state of mind, "would effectively nullify the protective purposes" of the federal securities statutes. Cf. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 200 (1963).

The Commission is charged with enforcing the federal securities laws for the protection of investors. Unlike a private plaintiff seeking to recover damages he has incurred, the Commission, in seeking an injunction, does not sue to vindicate its own rights; rather, it endeavors to protect the public interest and the interests of investors from violations of the law by obtaining prospective relief that requires the defendant to obey the securities laws in the future.[7] "An injunction is designed to protect the public against conduct, not to punish a state of mind."[8] The harm caused by a defendant's deceptive conduct in

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[7]In a Commission enforcement action, "the standards of the public interest not the requirements of private litigation measure the propriety and need for injunctive relief." *SEC* v. *Management Dynamics, Inc.*, 515 F. 2d 801, 808 (2d Cir. 1975), quoting *Hecht Co.* v. *Bowles*, 321 U.S. 321, 331 (1944). When the Commission seeks an injunction charging a past violation of the law, the courts generally require proof of a reasonable likelihood that the wrong will be repeated. See, *e.g.*, *SEC* v. *Koracorp Industries, Inc.*, 575 F. 2d 692, 698-699 (9th Cir.), cert. denied, 439 U.S. 953 (1978), quoting 3 L. Loss, *Securities Regulation* 1976 (2d ed. 1961); *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F. 2d at 808.

[8]*SEC* v. *World Radio Mission, Inc.*, 544 F. 2d 535, 541 (1st Cir. 1976).

securities transactions does not depend on his state of mind. As the court noted in *SEC* v. *Coven*, *supra*, 581 F. 2d at 1028, the "effects [of negligent conduct] on the public may be every bit as detrimental as those produced by intentional misconduct." If the Commission were required to prove in every injunctive proceeding alleging violation of the antifraud provisions of the federal securities laws that the defendant acted with an "intent to deceive, manipulate, or defraud,"[9] the Commission's ability to enforce the federal securities laws would be eroded significantly and investors would be deprived of needed protections.

2. In the three and a half years since *Hochfelder* was decided, the question expressly reserved by this Court in that case—"whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5" (425 U.S. at 194 n.12)—and the related question whether *scienter* is required in an injunctive proceeding under Section 17(a), have been the subject of substantial litigation, as evidenced by the fact that there have been at least 25 reported decisions in which the *scienter* requirement was raised as an issue.[10] In proceedings for injunctive relief brought under Section 10(b) and Rule 10b-5, there has been great uncertainty in the courts of

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[9] *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 188.

[10] See notes 11-13, *infra*.

appeals[11] and the district courts[12] as to whether *scienter* is an element. While the courts of appeals and most district

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[11]Since this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the First and Second Circuits have expressed the view that *scienter* is not required in Commission injunctive actions under Section 10(b). The Fifth Circuit has disagreed. Compare the court of appeals decision in this case (Pet. App. 13a-19a) and *SEC* v. *World Radio Mission, Inc.*, *supra*, 544 F. 2d at 540-541 & n.10, with *SEC* v. *Blatt*, 583 F. 2d 1325, 1333-1334 (5th Cir. 1978). The Ninth Circuit has assumed, without deciding, that *scienter* is not required under Section 10(b) in Commission injunctive actions. *SEC* v. *Arthur Young & Co.*, 590 F. 2d 785, 787 (1979); *SEC* v. *Koracorp Industries, Inc.*, *supra*, 575 F.2d at 701. Other courts of appeals have reserved decision on the issue. See, *e.g.*, *SEC* v. *Savoy Industries, Inc.*, 587 F. 2d 1149, 1172 (D.C. Cir. 1978), cert. denied, No. 78-932 (Feb. 21, 1979) (remanded for further consideration); *SEC* v. *American Realty Trust*, 586 F. 2d 1001, 1002 (4th Cir. 1978) (findings of violations on the basis of Section 17(a) only).

[12]Some district courts have expressed the view that *scienter* is not required in Commission injuntive actions under Section 10(b). *SEC* v. *Chatham*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,911 at 95,758 (D. Utah June 6, 1979); *SEC* v. *Paro*, 468 F. Supp. 635, 647-649 (N.D. N.Y. 1979); *SEC* v. *Western Geothermal & Power Corp.*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,920 at 95,859 (D. Ariz. May 23, 1979), appeal pending, No. 79-3422 (9th Cir.); *SEC* v. *Hart*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,454 at 93,645 (D.D.C. May 26, 1978); *SEC* v. *Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1978), aff'd, 590 F. 2d 785 (9th Cir. 1979); *SEC* v. *Shiell*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,190 at 92,386 (N.D. Fla. Sept. 27, 1977); *SEC* v. *Trans Jersey Bancorp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 95,818 at 90,950 (D.N.J. Dec. 14, 1976).

Other district courts have indicated that *scienter* is required under Section 10(b). *SEC* v. *Wills*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,712 at 94,769-94,770 (D.D.C. Dec. 14, 1978); *SEC* v. *Randell*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,362 (E.D. Va. Feb. 24, 1978), appeal pending, No. 78-1386 (4th Cir.); *SEC* v. *Southwest Coal & Energy Co.*, 439 F. Supp. 820, 825 (W.D. La. 1977), appeal pending, No. 78-1130 (5th Cir.); *SEC* v. *Cenco Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC* v. *American Realty Trust*, 429 F. Supp. 1148, 1171 (E.D. Va. 1977), rev'd on other grounds, 586 F. 2d 1001 (4th Cir. 1978); *SEC* v. *Bausch & Lomb Inc.*, 420 F. Supp. 1226, 1241 (S.D. N.Y. 1976), aff'd on other grounds, 565 F. 2d 8 (2d

courts addressing the issue have agreed that *scienter* is not required under Section 17(a), the issue is nonetheless continually litigated.[13]

Cir. 1977). In other cases in which the *scienter* issue has been raised, district courts have reserved decision. *SEC* v. *National Student Marketing Corp.*, 457 F. Supp. 682, 709-710 (D.D.C. 1978), appeals pending, Nos. 79-1051-1053 (D.C. Cir.); *SEC* v. *Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 831 (E.D. Wisc. 1978); *SEC* v. *Penn Central Co.*, 450 F. Supp. 908, 917-918 (E.D. Pa. 1978); *SEC* v. *Falstaff Brewing Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,583 at 94,471 (D.D.C. Oct. 28, 1978), appeal pending, No. 79-1467 (D.C. Cir.); *SEC* v. *Technical Resources, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,268 at 92,744 (S.D.N.Y. Dec. 22, 1977), aff'd without opinion, No. 78-6046 (2d Cir. Nov. 28, 1978).

[13]The court of appeals in this case and the other courts of appeals that have considered the issue after *Hochfelder* have concluded that *scienter* is not required in a Commission injunctive action under Section 17(a). Pet. App. 19a-20a; *SEC* v. *American Realty Trust, supra*, 586 F. 2d at 1006-1007; *SEC* v. *Coven, supra*, 581 F. 2d at 1026-1027; *SEC* v. *World Radio Mission, Inc., supra*, 544 F. 2d at 540-541. See also *SEC* v. *Arthur Young & Co., supra*, 590 F. 2d at 787 (assuming *scienter* is not required under Section 17(a)).

Most district courts have concluded that *scienter* is not required under Section 17(a). See, *e.g.*, *SEC* v. *Chatham, supra*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,911 at 95,758; *SEC* v. *Paro, supra*, 468 F. Supp. at 647-649; *SEC* v. *Wills, supra*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,712 at 94,770; *SEC* v. *Jos. Schlitz Brewing Co., supra*, 452 F. Supp. at 831; *SEC* v. *Century Mortgage Co.*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,777 at 95,053 (D. Utah Jan. 17, 1979); *SEC* v. *Western Geothermal & Power Corp., supra*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,920 at 95,859; *SEC* v. *Southwest Coal & Enegy Co., supra*, 439 F. Supp. at 826; *SEC* v. *Geotek, supra*, 426 F. Supp. at 726; *SEC* v. *Shiell, supra,* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,190 at 92,386. But see *SEC* v. *Cenco Inc., supra*, 436 F. Supp. at 200; *SEC* v. *American Realty Trust, supra*, 429 F. Supp. at 1171; *SEC* v. *Randell, supra*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,362. In several recent cases, district courts have reserved decision on this issue. *SEC* v. *National Student Marketing Corp., supra*, 457 F. Supp. at 709-710; *SEC* v. *Penn Central Co., supra*, 450 F. Supp. at 917-918; *SEC* v. *Technical Resources, Inc., supra*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,268 at 92,744.

Resolution by this Court of the basic question whether *scienter* must be proven in Commission injunctive proceedings brought under Section 10(b) or Section 17(a) would bring certainty to the administration of the federal securities laws[14] and would conserve the resources now being expended by the courts and parties, including the Commission, in litigating these issues.[15] As the court below observed with respect to Section 10(b), the question whether *scienter* is required in Commission injunctive actions under that provision is one "on which the final word will not rest with [the lower courts]" (Pet. App. 28a n.16, quoting *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F. 2d 90, 101 (2d Cir. 1978) (Friendly, J.)). That observation is likewise applicable to Section 17(a).

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[14]Uncertainty as to the *scienter* requirement has also extended to other types of proceedings. For administrative proceedings involving Section 10(b) and Section 17(a) where *scienter* has been an issue, see *Whitney* v. *SEC*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,913 (D.C. Cir. June 28, 1979) (Section 10(b) only); *Mawod & Co.* v. *SEC*, 591 F. 2d 588 (10th Cir. 1979); *Berdahl* v. *SEC*, 572 F. 2d 643 (8th Cir. 1978); *Nassar & Co.* v. *SEC*, 566 F. 2d 790 (D.C. Cir. 1977); *Collins Securities Corp.* v. *SEC*, 562 F. 2d 820 (D.C. Cir. 1977); *Arthur Lipper Corp.* v. *SEC*, 547 F. 2d 171 (2d Cir. 1976), rehearing denied, 551 F. 2d 915 (1977), cert. denied, 434 U.S. 1009 (1978) (Section 10(b) only).

[15]The question whether *scienter* is required under Section 10(b) or Section 17(a) has been raised in the following cases now pending before the courts of appeals: *SEC* v. *Falstaff Brewing Corp.*, Nos. 79-1467 (D.C. Cir.) (Section 10(b) only); *SEC* v. *National Student Marketing Corp.*, Nos. 79-1051-1053 (D.C. Cir.); *SEC* v. *Monarch Fund*, No. 79-6048 (2d Cir.) (Section 10(b) only); *SEC* v. *Mumford*, No. 78-1386 (4th Cir.); *Steadman* v. *SEC*, No. 77-2415 (5th Cir.) (administrative proceeding); *SEC* v. *Southwest Coal & Energy Co.*, No. 78-1130 (5th Cir.); *SEC* v. *Intertie, Inc.*, No. 78-3300 (9th Cir.); *SEC* v. *Blazon Corp.*, Nos. 77-1904, 77-2033 (9th Cir); *SEC* v. *Western Geothermal & Power Corp.*, No. 79-3422 (9th Cir.); *SEC* v. *Haswell*, No. 78-1048 (10th Cir.).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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