77-6091

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 77-6091

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

E. L. AARON & CO., INC., et al.,

Defendants,

PETER E. AARON,

Defendant-Appellant.

On Remand from the Supreme Court
of the United States

SUPPLEMENTAL BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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SUPPLEMENTAL BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

COUNTERSTATEMENT OF THE QUESTION PRESENTED

Did the district court properly find scienter, where appellant, a supervisor in a securities broker-dealer firm, was twice informed by counsel for an issuer of stock that salesmen under appellant's direct supervision were making fraudulent statements to promote the firm's sale of the issuer's stock and appellant "took no steps to prevent such conduct from recurring" and "did nothing whatever to indicate that such salesmanship was unethical, illegal, and should stop." Aaron v. Securities and Exchange Commission, 100 S. Ct. 1945, 1958 (1980) (Burger, C. J., concurring).

INTRODUCTION

On March 12, 1979, this Court issued an opinion in this injunctive action brought by the Securities and Exchange Commission, holding that the district court had properly entered a permanent injunction against appellant Peter E. Aaron enjoining him from committing further violations of the registration provisions of Section 5 of the Securities Act of 1933, 15 U.S.C. 77e, and the antifraud provisions of Section 17(a) of the Securities Act, 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 thereunder, 17 CFR 240.10b-5. Securities and Exchange Commission v. Aaron, 605 F.2d 612 (1979). This Court held proof of negligent misconduct to be sufficient to support an injunction against further violations of each of the antifraud provisions charged and therefore did not review the district court's finding that Mr. Aaron had acted with scienter by "'intentionally fail[ing] to terminate the false and misleading statements made by Schreiber and Jacobson, [the salesmen under appellant's supervision,] knowing them to be fraudulent * * * '." 605 F.2d at 619 n.9, quoting Securities and Exchange Commission v. E.L. Aaron & Co., [1977-1978] Fed. Sec. L. Rep. (CCH) ¶96,043 at 91,685 (S.D.N.Y. 1977).

Mr. Aaron filed a petition for a writ of certiorari in the Supreme Court limited to the question whether scienter is a necessary element of a Commission injunctive action for violations of the antifraud provisions. 1/

1/ In the Supreme Court, Mr. Aaron abandoned any argument that the injunction issued against him was improper insofar as it enjoined him from further violations of the registration provisions. See Aaron v. Securities and Exchange Commission, 100 S. Ct. 1945, 1949 n.1 (1980). Thus, this Court should not reconsider its prior determination that the district court's entry of an injunction restraining registration violations was proper.

Certiorari was granted, and on June 2, 1980, the Supreme Court issued its opinion in this case, holding that scienter is not a necessary element in a Commission injunctive action to enjoin further violations of subparagraphs (2) and (3) of Section 17(a), but that scienter is a prerequisite for an injunction restraining further violations of Section 17(a)(1), Section 10(b), and Rule 10b-5. In view of this Court's determination that it was not necessary to review the district court's scienter finding in order to affirm the issuance of the injunction "under any of the provisions in question," the Supreme Court vacated this Court's judgment and "remanded * * * for further proceedings consistent with [its] opinion." 100 S. Ct. at 1958.

In a separate opinion, Chief Justice Burger, concurring with respect to the need to prove scienter, expressed the opinion that

> "[n]o matter what mental state §10(b) and §17(a) were to require, it is clear that the District Court was correct here in entering an injunction against petitioner. Petitioner was informed by an attorney representing Lawn-A-Mat that two representatives of petitioner's firm were making grossly fraudulent statements to promote Lawn-A-Mat stock. Yet he took no steps to prevent such conduct from recurring. He neither discharged the salesmen, or rebuked them; he did nothing whatever to indicate that such salesmanship was unethical, illegal, and should stop. Hence, the District Court's findings (a) that petitioner 'intentionally failed' to terminate the fraud and (b) that his conduct was reasonably likely to repeat itself find abundant support in the record. In my view, the Court of Appeals could well have affirmed on that ground alone."

100 S. Ct. at 1958.

On September 2, 1980, this Court ordered that the parties file supplemental briefs on remand from the Supreme Court. The order stated that the parties should in particular "direct their attention to whether the judgment of the district court should be affirmed on the basis of the district court's finding of scienter," as suggested by Chief Justice

Burger's concurring opinion. As discussed below, Chief Justice Burger's observation that the finding of scienter "find[s] abundant support in the record" is correct (100 S. Ct. at 1958), and the injunction of the district court was thus properly issued with respect to its prohibition against further violations of each of the antifraud provisions involved in this case, including Section 17(a)(1), Section 10(b), and Rule 10b-5.

ARGUMENT

THE DISTRICT COURT'S FINDING OF SCIENTER IS AMPLY SUPPORTED BY THE RECORD AND THUS THERE IS A SUFFICIENT PREDICATE FOR THE INJUNCTION ISSUED AGAINST MR. AARON. 2/

The sole issue remaining for review on remand from the Supreme Court is whether the injunction issued by the district court, insofar as it enjoins Mr. Aaron from further violations of Section 17(a)(1), Section 10(b), and Rule 10b-5, 3/ "should be affirmed on the basis

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2/ The Commission relies in general on the statement of facts contained in its brief filed during this Court's initial review of this appeal. Therefore, this brief does not contain a separate statement of facts. Pertinent facts are discussed in the argument.

3/ The injunction (A. 824-826) prohibits Mr. Aaron from violating Sections 17(a)(1), (2), and (3), Section 10(b), and Rule 10b-5. Since subsections (2) and (3) of Section 17(a) do not require proof of scienter "before an injunction may issue" (100 S. Ct. at 1958), the Supreme Court's mandate does not require any reexamination of the district court's injunctive order insofar as it enjoins Mr. Aaron from further violations of those subsections.

of the district court's finding of scienter." 4/ Mr. Aaron makes two arguments with respect to this issue. He argues that his failure to take affirmative steps to terminate the fraudulent conduct of his salesmen was not the result of any "intent" to defraud because his inaction "was not due to any purpose on his part to defraud the public" (Br. 9) 5/ and that his conduct cannot be characterized as the type of recklessness that satisfies the scienter requirement (Br. 9; see also Br. 7 n.3). 6/ As the Commission demonstrated in its prior brief to this Court (Comm. Br. 6-9, 40-45) and further explains below, however, there is ample evidence in the record of Mr. Aaron's scienter, and his assertions to the contrary are without merit.

4/ The district court's findings of fact as to scienter may not be set aside unless they are clearly erroneous. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 43-44 (2d Cir.), cert. denied, 439 U.S. 1039 (1978). As this Court noted in Rolf,

> "'we may not substitute our judgment on facts for that of the trial judge, who was in a superior position to appraise the evidence [including the demeanor and credibility of witnesses], and we may not reverse his findings unless, on the entire record, we are * * * left with the definite and firm conviction that a mistake has been committed.'"

570 F.2d at 44, quoting Zenith Radio Corp. v. Hazeltine Research, Inc., 395 U.S. 100, 123 (1969).

5/ References in this brief to appellant's brief on remand are cited as "Br. __" and to his opening and reply briefs filed during this Court's initial consideration of this appeal as "Opening Br. __" and "Reply Br. __." References to the Commission's answering brief filed during this Court's initial review are cited as "Comm. Br. __." References to the appendix are cited as "A. __."

6/ Mr. Aaron also argues (Br. 11-13) that even if he was properly found to have violated Section 17(a), Section 10(b), and Rule 10b-5, the district court abused its discretion in entering an injunction against him in this case. As indicated above (n.3, supra), however, the Supreme Court's mandate requires only that this Court determine whether there was a sufficient showing of scienter to support the injunction to the extent that it enjoins Mr. Aaron from violating those provisions which require scienter as an element of the substantive violation. 100 S. Ct. at 1957-1958. The Court did not change the

(footnote continued)

A. The District Court's Finding of Scienter is Supported By Mr. Aaron's Reckless Disregard of His Salesmen's Fraudulent Activities.

Mr. Aaron apparently concedes that reckless behavior can be a predicate for liability under the antifraud provisions requiring scienter (Br. 7 n.3; id. at 9-10), but argues that he was not in fact reckless. He contends that his failure to terminate the fraudulent conduct of his salesmen "can only be characterized as carelessness or a result of poor judgment" and that his "inaction should not be considered a conscious imposition of unnecessary risk of deception on the public" (Br. 9).

6/ (footnote continued)

law with respect to the district court's power to enjoin further violations of the law when past violations have been proved; it remains a matter of "equitable discretion." Id. at 1958. Although the Court stated that the degree of intentional wrongdoing should be an "important factor" in the district court's exercise of discretion, it agreed with the Commission's position that once a past violation is proved scienter or the lack of it is merely "one of the aggravating or mitigating factors to be taken into account in exercising equitable discretion in deciding whether or not to grant injunctive relief." Ibid. (emphasis supplied). In its prior decision in this case, this Court stated that the factors considered by the district court apart from Mr. Aaron's scienter were "alone * * * sufficient to justify a permanent injunction." 605 F.2d at 624. A finding of scienter, this Court stated, would only "underscore the need for an injunction." Ibid. Therefore, if this Court determines that the district court's scienter finding is not clearly erroneous and thus that Mr. Aaron violated Section 17(a)(1), Section 10(b), and Rule 10b-5, the district court's judgment should be affirmed in all respects. If there is no such evidentiary predicate, the judgment should be affirmed insofar as it enjoins Mr. Aaron from further violations of Section 17(a)(2) and (3). In either case, however, the district court's exercise of discretion need not be reviewed once again.

Even in the view of Chief Justice Burger, who concurred separately in the judgment, "the District Court was correct here in entering an injunction against [Mr. Aaron]." 100 S. Ct. at 1958. Therefore, Mr. Aaron's reliance (Br. 11 n.4) on the dictum in Chief Justice Burger's concurring opinion, concerning the "drastic" nature of injunctive relief, is misplaced.

As shown below, (1) recklessness is, as Mr. Aaron concedes, an appropriate standard for assessing the liability of a broker-dealer firm supervisor for failing to terminate the fraud of salesmen under his supervision; and (2) under any articulation of the recklessness standard, Mr. Aaron's conduct was reckless.

1. Recklessness Satisfies the Scienter Requirement.

The Supreme Court, in its decision in the present case, 100 S. Ct. at 1950 n.5, and in its earlier decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976), reserved the question whether reckless behavior is a sufficient predicate for liability under Section 17(a)(1), Section 10(b), and Rule 10b-5. In reserving this question, however, the Court recognized that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability * * *." 425 U.S. at 194 n.12; 100 S. Ct. at 1950 n.5. This Court, subsequent to Hochfelder, has held that recklessness is generally a sufficient form of scienter for liability under Section 10(b) and Rule 10b-5. 7/ Every other

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7/ Oleck v. Fischer, 623 F.2d 791, 794-795 (1980); IIT v. Cornfeld, 619 F.2d 909, 922-925 (1980); Edwards & Hanly v. Wells Fargo Securities Clearance Corp., 602 F.2d 478, 484-485 (1979), cert. denied, 444 U.S. 1045 (1980); Rolf v. Blyth, Eastman Dillon & Co., supra, 570 F.2d at 44-48.

In holding that recklessness will generally satisfy the scienter requirement, this Court has recognized that it is "continu[ing] to follow [its] own [pre-Hochfelder] decisions." IIT v. Cornfeld, supra, 619 F.2d at 923, citing Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (1973) (en banc). See also Cohen v. Franchard Corp., 478 F.2d 115, 122-123, cert. denied, 414 U.S. 857 (1973); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (1971). Moreover, the Hochfelder decision itself recognized that this Circuit in its Lanza decision had rejected a negligence standard for damage actions, requiring instead a "reckless disregard for the truth" as a "form of scienter." 425 U.S. at 194 n.12.

(footnote continued)

court of appeals which has considered the question subsequent to the Hochfelder decision has also agreed that reckless behavior is generally sufficient. 8/

7/ (footnote continued)

While the proposed Federal Securities Code does not impose scienter as a requirement for injunctive actions, it adopts recklessness as an appropriate basis for liability for securities fraud charged in damage actions, where scienter is required by the Code. The Code defines scienter as follows: "A person makes (or * * * causes or gives substantial assistance to the making of) a misrepresentation with 'scienter' if he knows that he is making a misrepresentation (or a misrepresentation is being made) or acts in reckless disregard of whether that is so." ALI Federal Securities Code §202(147)(Proposed Official Draft 1980). Under the Code's definition of the term, a "misrepresentation" includes "an omission to state a material fact necessary to prevent the statements made from being misleading * * * ." Id. at §202(96)(A).

8/ Six circuits in addition to this Court have held that recklessness generally suffices for liability under Section 10(b) and Rule 10b-5. Third Circuit: Healey v. Catalyst Recovery of Pennsylvania, Inc., 616 F.2d 641, 649-651 (1980); McLean v. Alexander, 599 F.2d 1190, 1196-1202 (1979); Coleco Industries, Inc. v. Berman, 567 F.2d 569, 574 (1977), cert. denied, 439 U.S. 830 (1978). Fifth Circuit: Securities and Exchange Commission v. Southwest Coal & Energy Co., 624 F.2d 1312, 1321 (1980); Broad v. Rockwell International Corp., 614 F.2d 418, 439-441, rehearing granted, 618 F.2d 396 (1980); First Virginia Bankshares v. Benson, 559 F.2d 1307, 1314, rehearing denied, 564 F.2d 416 (1977), cert. denied, 435 U.S. 952 (1978). Sixth Circuit: Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023-1025 (1979); see also Adams v. Standard Knitting Mills, Inc., 623 F.2d 422 (1980) (Section 14(a)). Seventh Circuit: Wright v. Heizer Corp., 560 F.2d 236, 251-252 (1977), cert. denied, 434 U.S. 1066 (1978); Sanders v. John Nuveen & Co., 554 F.2d 790, 792-793 (1977); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1039-1040, 1043-1048, cert. denied, 434 U.S. 875 (1977); Bailey v. Meister Brau, Inc., 535 F.2d 982, 993-994 (1976). Eighth Circuit: Berdahl v. Securities and Exchange Commission, 572 F.2d 643, 647 n.6 (1978). Ninth Circuit: Pegasus Fund, Inc. v. Laraneta, 617 F.2d 1335, 1340-1341 (1980); Keirnan v. Homeland, Inc., 611 F.2d 785, 787-788 (1980); Spectrum Financial Companies v. Marconsult, Inc., 608 F.2d 377, 380-381 (1979), cert. denied, 100 S. Ct. 2153 (1980); Nelson v. Serwold, 576 F.2d 1332, 1336-1338, cert. denied, 439 U.S. 970 (1978). Presumably, these courts would find that reckless behavior also violates Section 17(a)(1).

Appellant cites the district court's opinion in Securities and Exchange Commission v. American Realty Trust, 429 F. Supp. 1148, 1171 n.8

(footnote continued)

Although this Court has held recklessness sufficient for the imposition of liability for principals, certain recent decisions of this Court have suggested that the recklessness question has not been resolved with respect to certain types of aiders and abettors. In Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44, cert. denied, 439 U.S. 1039 (1978) (footnote omitted), this Court held that "at least where, as here, the alleged aider and abettor owes a fiduciary duty to the defrauded party, recklessness satisfies the scienter requirement." In explanation, the Rolf opinion stated that a fiduciary relationship between the aider and abettor and the deceived investor (which would provide a duty to act to protect the investor's interests) is "[t]he relationship most logically subjected to a recklessness standard * * *" because liability premised on a fiduciary's recklessness in failing to investigate evidence of fraud practiced on his beneficiary "is a far cry from * * * [liability] for simple negligence." Id. at 45. The Rolf opinion, however, did not address what other relationships would "logically [be] subject[] to a recklessness standard" because the defendant aider and abettor in that case was found to have been in a fiduciary type relationship with the deceived investor. Id. at 44-45 & n.9. 9/ See also Oleck v. Fischer, 623

8/ (footnote continued)

(E.D. Va. 1977), as a case indicating that "recklessness does not satisfy Hochfelder" (Br. 7 n.3). The district court's opinion was later reversed, however, without discussion of the recklessness question. Securities and Exchange Commission v. American Realty Trust, 586 F.2d 1001, 1002 (4th Cir. 1978).

9/ The Court stated in Rolf that it did not need to "reach the question whether recklessness satisfies the scienter requirement where the alleged aider and abettor owes no duty of disclosure and of loyalty to the defrauded party." 570 F.2d at 44 n.9.

F.2d 791, 794 (2d Cir. 1980); Edwards & Hanly v. Wells Fargo Securities Clearance Corp., 602 F.2d 478, 485 (1979), cert. denied, 444 U.S. 1045 (1980). 10/

In contrast to certain language in the recent decisions of this Court noted above, this Court, prior to Hochfelder, applied a recklessness standard in the aiding and abetting context without indicating that the presence or absence of a fiduciary relationship to the deceived party had any significance. In Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (1973), for example, this Court, en banc, applied a recklessness standard in determining whether an outside director had aided and abetted the fraud of certain officers and directors of his corporation by failing to discover and terminate their fraud. In fact, the director was not in a fiduciary relationship with the deceived party -- another corporation which was merging with the director's corporation. Applying a recklessness standard to the facts of the case, this Court in Lanza held that, since the director did not even have any notice of a possible material failure of disclosure, the director's failure to inquire into and discover the fraud "cannot be characterized as * * * reckless." Ibid.

10/ Although this Court suggested in Edwards & Hanly that the defendant aider and abettor in that case could not be liable under a recklessness standard because he was not in a fiduciary relationship with the defrauded party, the case was decided on another ground. 602 F.2d at 485. Subsequent to the Edwards & Hanly decision, a district court in this circuit recognized that the liability of an aider and abettor who is not in a fiduciary relationship with a defrauded party for reckless misconduct remains an "undecided question." Greene v. Emersons, Ltd., 86 F.R.D. 66, 70 (S.D.N.Y. 1980) (reserving the question whether the recklessness standard applies to outside directors). See Oleck v. Fischer, supra, 623 F.2d at 794.

Two other post-Hochfelder decisions of this Court have not reached the question whether a recklessness standard applies to non-fiduciary aiders and abettors. See Oleck v. Fischer, supra, 623 F.2d at 795; IIT v. Cornfeld, supra, 619 F.2d at 925.

As indicated from the foregoing discussion, none of the decisions of this Court constitutes a square holding on whether recklessness is sufficient to establish scienter on the part of an aider and abettor defendant who is not in a fiduciary relationship with the deceived investor. This Court's Lanza decision, however, in applying the recklessness standard to aiders and abettors whether or not their relationship with the victim of the fraud can be characterized as fiduciary in nature, is consistent with post-Hochfelder decisions of the Third, Sixth, Seventh, and Ninth Circuits, 11/ and, in our judgment, represents the better view. Moreover, there is nothing in Hochfelder or Aaron which suggests that fiduciaries should be treated differently from nonfiduciaries in this respect. See, e.g., Aaron v. Securities and Exchange Commission, supra, 100 S. Ct. at 1954 ("Section 10(b) * * * applies with equal force to both fiduciary and nonfiduciary transactions in securities"). Particularly where, as here, the alleged aider and abettor has a duty of supervision over the primary violator -- and hence a duty to act to prevent the fraud of the person being supervised 12/

11/ See, e.g., Pegasus Fund, Inc. v. Laraneta, 617 F.2d 1335, 1339-1341 (9th Cir. 1980) (accountant charged as an aider and abettor); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 n.22 (6th Cir. 1979) ("no reason to impose" a fiduciary limitation); Coleco Industries, Inc. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977), cert. denied, 439 U.S. 830 (1978) (accountant charged as an aider and abettor); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1039-1040, 1043-1048 (7th Cir.), cert. denied, 434 U.S. 875 (1975) (directors and a merger broker charged as aiders and abettors).

12/ Although Mr. Aaron argued on the previous occasion this case was before this Court that he was not under a duty to prevent the fraudulent conduct of his salesmen, this Court decided that issue adversely to him in its prior opinion and he did not raise the issue in the Supreme Court. See 100 S. Ct. at 1948 ("petitioner was a managerial employee * * * charged with supervising the sales made by * * * registered representatives"). In any event, Mr. Aaron's duty to act cannot be disputed. See Comm. Br. 17-25. See also 5A A. Jacobs, The Impact of Rule 10b-5, §214.02 at 9-128-132 (Revised ed. 1979) (collecting cases); Sections 15(b)(4)(E) and 15(b)(6) of the Securities Exchange Act, 15 U.S.C. 78o(b)(4)(E) and 78o(b)(6).

-- a recklessness standard is appropriate. 13/ Therefore, consistent with Hochfelder, Aaron, this Court's Lanza decision, and decisions of other courts of appeals, Mr. Aaron's liability should be determined in accordance with a recklessness standard whether or not he is deemed to be a fiduciary to the victims of the fraud.

Nevertheless, Mr. Aaron, as a registered representative of a broker-dealer firm with supervisory duties over the firm's salesmen (see note 12, supra) was in a "special relationship * * * that is fiduciary in nature" with the firm's customers. Edwards & Hanly v. Wells Fargo Securities Clearance Corp., supra, 602 F.2d at 485 (a transfer agent in the circumstances did not have such a relationship with a defrauded broker-dealer); see Rolf v. Blyth, Eastman Dillon & Co., supra, 570 F.2d at 45. Thus, like the registered representative in Rolf, Mr. Aaron is liable under a recklessness standard for aiding and abetting his salesmen's fraudulent conduct, even if a recklessness standard would not govern in the case of a non-fiduciary aider and abettor. 14/

13/ As Judge Friendly has noted, "inaction can create aider and abettor liability * * * when there is a conscious or reckless violation of an independent duty to act." IIT v. Cornfeld, 619 F.2d 909, 927 (2d Cir. 1980). The proposed Federal Securities Code, supra, would, if enacted by Congress, codify this principle. The Code provides that "[i]naction or silence when there is a duty to act or speak may be a fraudulent act." Id. at §202(61)(B); id. at §202(149).

14/ As noted above, like Mr. Aaron, the aider and abettor in Rolf, Michael Stott, was a registered representative of a broker-dealer firm. 570 F.2d at 41. In Rolf this Court found Mr. Stott to be a fiduciary on the basis of the facts that, although plaintiff's account was managed by an independent investment advisor (the principal violator in the case), the account and its accompanying trading commissions were left with Mr. Stott's firm and the plaintiff reasonably placed trust and confidence in Mr. Stott to supervise the trading activities of

(footnote continued)

2. Mr. Aaron's Conduct Was Reckless.

a. Failure to Investigate When One Is on Notice of the Possibility of Fraud Constitutes Recklessness.

Since the Supreme Court in Hochfelder left open the question whether recklessness suffices for liability under Rule 10b-5, it did not define the type of conduct that constitutes recklessness. Aaron similarly contains no definition of recklessness. As the Aaron decision makes clear, however, Hochfelder merely held that, under antifraud provisions requiring proof of scienter, allegations of "simple negligence" will not suffice. 100 S. Ct. at 1952. In Hochfelder, the plaintiff did not allege that the defendant accounting firm had any reason to suspect the existence of the fraud which it allegedly aided and abetted. 425 U.S. at 190. The plaintiff merely alleged that if defendant "Ernst & Ernst had conducted a proper audit" it would have discovered facts which would have led to a Commission "investigation * * * that would have revealed the fraudulent scheme." Ibid. This type of culpability -- ordinary negligence -- was held to be insufficient under Rule 10b-5.

14/ (footnote continued)

the investment advisor. Id. at 41-43. Although in the present case Aaron & Co. was acting as a securities dealer trading with its customers for its own account rather than, as in Rolf, an agent executing the trades of its customers, Mr. Aaron's relationship with the firm's customers should nonetheless be recognized as fiduciary in nature. Securities dealers are often treated as fiduciaries because of the great trust and confidence which investors place in them. See generally 3 L. Loss, Securities Regulation 1474-1508 (2d ed. 1961); 5A A. Jacobs, supra, §210.03 at 9-10-17; S. Jaffe, Broker-Dealers and Securities Markets 145-148 (1977). Since supervisory personnel are responsible for ensuring that the firm's duties to its customers are carried out, they may reasonably be treated as fiduciaries for the purpose of applying a recklessness standard.

Like the Hochfelder holding, the pre-Hochfelder decisions of this Court did not permit damage liability for "fail[ure] to detect * * * material facts when [there was] no reason to suspect their existence" even if the failure to discover such facts was the result of negligence. Cohen v. Franchard Corp., 478 F.2d 115, 123 (1973) (emphasis supplied). This Court had held in Lanza that proof of reckless behavior was required, and it defined recklessness in terms of

> "whether the defendants * * * failed or refused after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort."

Lanza v. Drexel & Co., supra, 479 F.2d at 1306 n.98 (citation omitted, emphasis supplied); see Cohen v. Franchard Corp., supra, 478 F.2d at 123. As Judge Mansfield observed prior to Hochfelder, an appropriate standard of liability meeting the scienter requirement mandated by Congress need

> "not permit top corporate officials and those aiding and abetting them to escape liability by pleading ignorance where it can be shown that red flags putting them on notice or providing warning signals of either undisclosed or misrepresented facts of a material nature were readily apparent to all and that a routine check would have disclosed the misrepresentation."

Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 398 (2d Cir.), cert. denied, 414 U.S. 910 (1973) (concurring and dissenting). The formulation of recklessness utilized by this Court prior to Hochfelder thus fully differentiated between negligence, as was involved in Hochfelder, and the culpability which constitutes scienter. Failure to investigate when one is on notice of the possibility of fraud is a form of culpability different in kind, not merely in degree, from the failure to discover facts which would put one on notice of the possibility of fraud; it is a form of recklessness, not mere negligence.

Although, as we noted above, subsequent to Hochfelder the courts have uniformly adopted recklessness as a sufficient form of culpability under the antifraud provisions requiring scienter, they have not agreed as to its articulation. The Ninth Circuit has recently adopted this Court's pre-Hochfelder formulation of recklessness, stating that

> "defendants [have] acted recklessly if they had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary effort."

Kiernan v. Homeland, Inc., 611 F.2d 785, 788 (1980), citing Lanza v. Drexel & Co., supra, and Cohen v. Franchard Corp., supra. 15/ On the other hand, the Third, Fifth and Seventh Circuits have adopted a more rigorous formulation, requiring at least an "extreme" departure from the standards of ordinary care in circumstances where the danger of deception is "so obvious that the actor must have been aware of it." 16/ This more rigorous articulation of recklessness reflects the concern that a definition that is too "liberal" might obliterate the "distinction between 'scienter' and 'negligence'" and thus permit liability on a basis inconsistent with Hochfelder. 17/

15/ Compare Pegasus Fund, Inc. v. Laraneta, supra, 617 F.2d at 1339-1341 (discussing a "flexible duty" standard).

16/ Sundstrand Corp. v. Sun Chemical Corp., supra, 553 F.2d at 1045, quoting Franke v. Midwestern Oklahoma Development Authority, 428 F. Supp. 719, 725 (W.D. Okla. 1976); see Healey v. Catalyst Recovery of Pennsylvania, Inc., supra, 616 F.2d at 649; McLean v. Alexander, supra, 499 F.2d at 1198; Broad v. Rockwell International Corp., supra, 614 F.2d at 440. Although the Sixth Circuit has not had an occasion to "precisely define what constitutes reckless behavior," it has expressed "general agreement" with the more rigorous articulation of recklessness adopted by the Third, Fifth and Seventh Circuits. Mansbach v. Prescott, Ball & Turben, supra, 598 F.2d at 1025.

17/ Sanders v. John Nuveen & Co., supra, 554 F.2d at 793. See also Wright v. Heizer Corp., supra, 560 F.2d at 251-252.

Such a liberal definition, it is reasoned, would disrupt the carefully drawn scheme of express damage provisions of the federal securities laws. 18/

Subsequent to Hochfelder, this Court has not had occasion to determine whether its prior articulation of the recklessness standard satisfies the Hochfelder scienter requirement. In Rolf v. Blyth, Eastman Dillon & Co., supra, 570 F.2d at 47, this Court held that the more rigorous formulation of recklessness adopted by the Third, Fifth and Seventh Circuits did satisfy the scienter requirement. But because this Court found in Rolf that the defendant's conduct met that more rigorous formulation, it did not "determine whether [the defendant's] conduct would qualify as recklessness under a less strict test * * *." Ibid.

We believe that the formulation of recklessness used by this Court prior to Hochfelder is correct. The concerns that led to the adoption of a more rigorous standard by certain other courts -- that too liberal a standard would disrupt the scheme of express damage remedies and conflict with the Hochfelder holding by obliterating the distinction between scienter and negligence — does not justify application in this case of an articulation more rigorous than the one employed by this Court prior to Hochfelder. Since the present case is a Commission action for injunctive relief, the potential for disruption of the scheme of express damage remedies "obviously has no

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18/ Sanders v. John Nuveen & Co., supra, 554 F.2d at 793. While the formulation adopted by the Third, Fifth, and Seventh Circuits appears to be more rigorous than this Court's pre-Hochfelder articulation of recklessness (see Steinberg & Gruenbaum, Variations of "Recklessness" After Hochfelder and Aaron, 8 Securities Regulation L.J. 179, 181-183 (1980)), both establish an objective test of recklessness. Even under the more rigorous formulation, all that is required is an objectively obvious risk. The danger of misleading investors "need not be known, * * * [but only be] so obvious that any reasonable man would have known of it." Mansbach v. Prescott, Ball & Turben, supra, 598 F.2d at 1025 (emphasis supplied). See also McLean v. Alexander, supra, 599 F.2d at 1198. But see Sundstrand Corp. v. Sun Chemical Corp., supra, 553 F.2d at 1045.

applicability" here. Aaron v. Securities and Exchange Commission, supra, 100 S. Ct. at 1952 n.9. 19/ Moreover, as we noted above, this Court's pre-Hochfelder standard does not obliterate the distinction between negligence and scienter, because it requires proof that the defendant was on notice of facts giving him reason to suspect the existence of deception. The standard thus sufficiently differentiates between negligent failure to discover evidence of deception, as was involved in Hochfelder, and reckless failure to investigate facts evidencing the possibility of deception. 20/ Since "Hochfelder should be read to go no further than its specific holding that mere negligence is not enough for liability," 21/ there is no reason why a further distinction between negligence and scienter should be created. Furthermore, a formulation of recklessness which is too stringent can have serious adverse effects on the securities markets. In the context of the broker-dealer industry, it would place a premium on ignorance and deprive brokerage firm customers of the protections which they expect when dealing with professionals in the industry.

19/ But see Securities and Exchange Commission v. Southwest Coal & Energy Co., supra, 624 F.2d at 1321.

20/ Even in a criminal context, a defendant will be presumed to have knowledge when he has "deliberately closed his eyes to facts which he had a duty to see * * *." United States v. Benjamin, 328 F.2d 854 (2d Cir.), cert. denied, 377 U.S. 953 (1964). See also United States v. Sarantos, 455 F.2d 877, 881 (2d Cir. 1972); Costello v. United States, 255 F.2d 389 (8th Cir.), cert. denied, 358 U.S. 830 (1958).

21/ Mansbach v. Prescott, Ball & Turben, supra, 598 F.2d at 1025. See also United States v. Chiarella, 588 F.2d 1358, 1370 (2d Cir. 1978), reversed on other grounds, 445 U.S. 222 (1980). As noted supra (n.16), the Mansbach court did not have to define precisely the contours of reckless behavior. 598 F.2d at 1025 n.36.

b. Under Any Formulation of Recklessness, Mr. Aaron's Conduct Was Reckless.

Under either this Court's pre-Hochfelder standard or the more rigorous formulation adopted by certain other circuits (see pages 14-15, supra), Mr. Aaron was reckless. Mr. Aaron was found to be liable for antifraud violations not for failing to discover the fraud of his salesmen, but rather for failing to terminate that fraud after he had been twice put on notice of the fraud by a representative of the issuer. 22/ On two occasions, Mr. Aaron was informed by the issuer's counsel that the statements being made by his salesmen were false and misleading (A. 276, 426, 427-428). On the first occasion, Mr. Aaron merely called one of the salesmen and told him to "talk to" the counsel for the issuer and "take care of it" (A. 426). Thereafter, when Mr. Aaron was informed that the fraudulent sales activities were continuing despite the warnings from the company's counsel and his request that the salesmen take care of the matter, he again merely relayed the complaint to one of the salesmen (see A. 428). Although he now claims that he believed that his salesmen would discontinue their fraudulent selling campaign (Br. 9-10), there is no evidence that he ever investigated to determine whether their misconduct had in fact ceased. 23/ As a result of his failure to take action, the fraudulent

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22/ The fact that the salesmen's misrepresentations concerning Lawn-A-Mat's financial condition and future plans were called to Mr. Aaron's attention by an attorney for the issuer is certainly sufficient to put Mr. Aaron on notice of the falsity of his salesmen's representations. But even if Mr. Aaron thought it necessary to verify the accuracy of the information he received from the issuer's counsel, Mr. Aaron, as the Supreme Court noted, "had reason to know" that that information was accurate (and thus that his salesmen's statements were false); he maintained Lawn-A-Mat's due diligence files which contained reports revealing a deteriorating financial condition and no future plans like those described by the salesmen. 100 S. Ct. at 1948; see 605 F.2d at 615; A. 807.

23/ In his initial briefs (Opening Br. 44; Reply Br. 5-6), Mr. Aaron argued that in spite of the warnings of the issuer's counsel he believed that

(footnote continued)

activities of the salesmen continued (A. 427-429, 639). Whatever one would conclude had Mr. Aaron not received a second warning of his salesmen's misconduct, in these circumstances the record clearly establishes that Mr. Aaron disregarded facts indicating that his salesmen were continuing to engage in fraud, and thus his conduct was reckless under this Court's pre-Hochfelder formulation of the term. Moreover, the risk of the salesmen's continuing fraud was "so obvious" that Mr. Aaron's disregard of their activities was reckless even under the more rigorous standard employed by certain other circuits.

B. Even If Reckless Behavior Does Not Satisfy the Scienter Requirement Here, the District Court Correctly Found Scienter on Mr. Aaron's Part Because He Failed to Terminate His Salesmen's Fraudulent Activities When He Knew that Their Deception of the Firm's Customers Would Continue.

Since, as we have demonstrated above, proof of reckless behavior satisfies the scienter requirement and the record shows that Mr. Aaron recklessly failed to terminate the fraudulent activities of his salesmen while under a clear duty to prevent such activities, this Court need not reach the additional issue raised by Mr. Aaron -- whether the record supports a finding that Mr. Aaron's failure to terminate the fraud of his salesmen resulted from more than recklessness. Nevertheless, even assuming arguendo that proof of reckless behavior does not satisfy the scienter requirement,

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23/ (footnote continued)

certain of the statements being made by his salesmen were true (see Comm. Br. 41). In his supplemental brief on remand (Br. 9-10), he appears to have abandoned that argument; while admitting that he was twice "made aware that misrepresentations were being made," he contends that he believed that the salesmen "would discontinue them" (Br. 9-10, emphasis supplied). In any event, in the circumstances here, an actual belief by Mr. Aaron in the truth of the salesmen's representations would not be a defense to his reckless disregard of the distinct possibility of their falsity. See pp. 13-17, supra.

the record fully supports the district court's finding of scienter, since the record shows that he knew that his salesmen's fraudulent activities would continue. In spite of the warnings he twice received, Mr. Aaron, in the words of Chief Justice Burger, "neither discharged the salesmen, or rebuked them" nor did he do anything "to indicate that such salesmanship was unethical, illegal and should stop" (100 S. Ct. at 1958; Comm. Br. 9; A. 638-639). In these circumstances, the district court correctly found scienter on Mr. Aaron's part because the record demonstrates that he failed to terminate his salesmen's fraudulent activities knowing that their deception of the firm's customers would continue.

C. Although Proof of a Purpose to Defraud Is Not Required, the Record Demonstrates Such a Purpose in this Case.

1. The Concept of Intent Embraces Knowledge.

Mr. Aaron argues that he could not have possessed "scienter" as defined by the Supreme Court in Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 193 n.12, and Aaron v. Securities and Exchange Commission, supra, 100 S. Ct. at 1950 n.5 -- that is, "a mental state embracing intent to deceive, manipulate, or defraud" -- because the evidence does not reflect "any purpose on his part to defraud" (Br. 9). In substance, he argues that the "intent" referred to in Hochfelder and Aaron includes only the desire to bring about deception. As we demonstrate below, Mr. Aaron's highly restrictive view of intent has never been the law and is not required by Hochfelder and Aaron; rather, under the circumstances here, knowing acquiescence in deception is sufficient to establish intent.

Under traditional principles of law, a person's conduct is intentional if engaged in either for the purpose of accomplishing a particular result or with knowledge that the result is likely to follow; in other words,

a person is presumed to intend the natural consequences of his conduct. 1 F. Harper & F. James, Law of Torts 216 (1956); W. Prosser, Law of Torts 31-32 (4th ed. 1971); 1 Jones on Evidence 166-168 (6th ed. 1972). Even if this were a criminal prosecution, the requirement of intent could be satisfied by proof of knowledge or awareness:

> "[I]t is now generally accepted that a person who acts (or omits to act) intends a result of his act (or omission) * * * when he knows that the result is practically certain to follow from his conduct, whatever his desire may be as to that result."

United States v. United States Gypsum Co., 438 U.S. 422, 445 (1978) (emphasis supplied), quoting W. LaFave & A. Scott, Criminal Law 196 (1972). See also Sandstrom v. Montana, 442 U.S. 510, 525-526 (1979). Since the presence of an aggravated form of intent is generally not required even for criminal punishment, the "distinction between knowledge and purpose has not been considered important" in the law. United States v. United States Gypsum Co., supra, 438 U.S. at 445, quoting LaFave & Scott, supra, at 196. Accordingly, the Supreme Court held in the United States Gypsum case, in the context of a criminal prosecution for antitrust violations, that the government need not demonstrate that the defendant's conduct "was undertaken with the 'conscious object' of producing" an anticompetitive result but only that the conduct was undertaken "with knowledge" that such a result "would most likely follow." Id. at 444.

Consistent with this general understanding of intent, the common law of deceit likewise does not require proof of a desire to defraud on the part of a defendant, but only knowledge that deception is a probable consequence of his conduct. See Restatement of Torts §531, Comment a (1938); Restatement (Second) of Torts §531, Comment c (1977). The common law of deceit

similarly does not require proof of any motive to defraud. 24/

Nothing in the Hochfelder or Aaron decisions, which impose a scienter requirement under Section 17(a)(1), Section 10(b), and Rule 10b-5, indicates that this general understanding of intent should not be applied under these antifraud provisions. Although the Hochfelder and Aaron decisions define the term "scienter" as "embracing intent to deceive, manipulate, or defraud" (425 U.S. at 193-194 n.12 (emphasis supplied); 100 S. Ct. at 1950 n.5 (emphasis supplied)), they do not even suggest that for purposes of deceptive conduct, such as the conduct involved here, this "intent" must include the unusual, extra ingredient of purpose. 25/

Indeed, this Court has read the Hochfelder decision in the criminal context as only eliminating negligence as a basis for liability and not as "establish[ing] a standard of specific intent to defraud." United States v. Chiarella, 588 F.2d 1358, 1370 (1978), reversed on other grounds, 445 U.S. 222 (1980). For several reasons this Court's reading of Hochfelder is correct, and a similar reading of Aaron is compelled. First, in both decisions the Supreme Court stated that the term "scienter" embraces "knowing or intentional misconduct." 425 U.S. at 197 (emphasis supplied); 100 S. Ct.

24/ Even in the case generally credited with establishing the strict scienter requirement, Derry v. Peek, 14 App. Cas. 337 (House of Lords 1889), all that was required was knowledge of the falsity of a statement or reckless disregard of its truth. In Derry, Lord Herschell stated that "the motive of the person guilty of it [the false statement] is immaterial." Id. at 374; see W. Prosser, Law of Torts 700 (4th ed. 1971); Bucklo, The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder, 29 Stan. L. Rev. 213, 229 (1977) ["Bucklo"].

25/ The only discussion in Hochfelder of purpose is in relation to manipulation, a specialized form of misconduct which Section 10(b) authorizes the Commission to proscribe. See 425 U.S. at 199. Section 10(b), however, covers both "manipulative" and "deceptive" practices, and we are here concerned only with the deception aspect of that provision.

at 1952 (emphasis supplied). As this Court has observed, the Supreme Court's use of the word "knowing" indicates a concept of intent much broader than a specific intent to cause a particular result. 26/ As the Court of Appeals for the District of Columbia Circuit recently held, "knowledge of * * * the nature and consequences" of one's conduct establishes scienter. Securities and Exchange Commission v. Falstaff Brewing Corp., [Current] Fed. Sec. L. Rep. (CCH) ¶97,505 at 97,641 (1980). 27/ Second, in both Hochfelder and Aaron the Supreme Court, as discussed above, indicated that scienter could also embrace reckless behavior. See 425 U.S. at 193-194 n.12; 100 S. Ct. at 1950 n.5. Since reckless behavior by definition involves a disregard of consequences rather than purposeful conduct, the Supreme Court's suggestion that such misconduct could suffice as a form of scienter is flatly inconsistent with the notion that the Court intended to require proof of a desire to bring about deception. And third, without a clear indication to the contrary, the Supreme Court's Hochfelder and Aaron opinions should not be read as interpreting Sections 17(a) and 10(b) in a manner "more restrictive in scope

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26/ Rolf v. Blyth, Eastman Dillon & Co., supra, 570 F.2d at 45 & n.12 ("scienter is not a rigid concept encompassing only the definitive intent to accomplish a specific purpose"). See also Nelson v. Serwold, supra, 576 F.2d at 1337 (the Supreme Court did not mean to suggest that "a particularly aggravated intent" was required); Bucklo, supra, at 219.

27/ The further element of knowledge of the illegality of one's acts clearly is not required to establish scienter. See Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 181 n.7 (2d Cir. 1976), rehearing denied, 551 F.2d 915 (1977), cert. denied, 434 U.S. 1009 (1978). See also United States v. Chiarella, supra, 588 F.2d at 1370-1371. As Judge Friendly observed in Arthur Lipper, "even in the criminal context neither knowledge of the law violated nor the intention to act in violation of the law is generally required for conviction." Ibid. "If a man intentionally adopts certain conduct in circumstances known to him, and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense which the law even considers intent." Ibid., quoting Ellis v. Carter, 206 U.S. 246, 257 (1907).

than [their] common law analogs," 28/ which as noted above do not require a purpose or a motive to defraud. The federal securities laws were intended "to expand common law notions of the elements of fraud," not to restrict them. 29/

Thus, consistent with the general understanding of intent, both in civil and criminal law, as well as with the Hochfelder and Aaron decisions, proof of a purpose to defraud is not required to establish a violation of Section 17(a)(1), Section 10(b), and Rule 10b-5. Knowledge of the facts is sufficient to establish the intent required for a violation of these provisions.

Nor is there any reason to deviate from this general understanding of intent in the context of aiding and abetting liability. Where, as here, the aider and abettor has a duty to act to prevent the continuation of a primary violation (see note 12, supra), the element of intent is satisfied by his knowledge of the primary violator's misconduct and his knowing failure to terminate that misconduct. IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980). 30/ There is no additional requirement of a desire on the part of such

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28/ Sundstrand Corp. v. Sun Chemical Corp., supra, 553 F.2d at 1044.

29/ Securities and Exchange Commission v. Coven, 581 F.2d 1020, 1026 (2d Cir. 1978), cert. denied, 440 U.S. 950 (1979).

30/ In IIT, this Court summarized the requirements for aiding and abetting under the securities laws as "(1) the existence of a securities law violation by the primary * * * party; (2) 'knowledge' of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation." 619 F.2d at 922. In this case, only the second element, the "knowledge" requirement, which "reckless conduct will generally satisfy" (id. at 923), is in issue. There is no dispute that the salesmen committed primary violations with intent to deceive. And, as noted above (nn.12-13), there is no dispute that Mr. Aaron's failure to act when he had a duty to prevent the salesmen's primary violations satisfies the substantial assistance requirement.

an aider and abettor to cause the primary violation to occur. 31/ His knowing acquiescence aids and abets the violation whether or not that was his desire. In the present case, therefore, Mr. Aaron's conduct in knowingly failing to terminate the fraud is, under general principles of law, intentional and an appropriate object of deterrence by injunctive relief.

2. In Any Event, Mr. Aaron's Misconduct Was Not Only Knowing But Also Purposeful.

Even if application of a higher level of "intent," limited to a purpose to permit the fraud to continue, were appropriate here, such a purpose is shown by the record. When Mr. Aaron contacted one of the salesmen responsible for the fraudulent statements and asked him to "take care of" the matter (A. 426), the salesmen continued their fraudulent activities in an effort to generate profits not only for themselves but for the firm (A. 458, 739-744). Hence, the generation of profits provided Mr. Aaron's purpose. 32/ In light of the profitable nature of the misconduct to the firm, Mr. Aaron's failure to do anything substantial to prevent the misconduct from continuing when it was brought to his attention on a second occasion must be viewed as purposeful.

31/ This Court need not address the question whether a purpose to defraud is required where, unlike the case here, the aider and abettor has no duty to act but nevertheless lends assistance to the primary violation by his inaction. See IIT v. Cornfeld, supra, 619 F.2d at 925; Edwards & Hanley v. Wells Fargo Securities Clearance Corp., supra, 623 F.2d at 484; Woodward v. Metro Bank of Dallas, 522 F.2d 84, 97 (5th Cir. 1975).

32/ Appellant argues that it was not shown that he "expected to profit greatly" from the false representations which were made (Br. 13, emphasis supplied). Implicit in this statement is the concession that he expected to profit indirectly to some extent from profits resulting to his father's firm. In any event, as this Court has observed, corporate officials can be motivated to participate in fraudulent transactions which result in an advantage to "their corporations." Lanza v. Drexel & Co., supra, 479 F.2d at 1302.

CONCLUSION

For the foregoing reasons as well as the reasons set forth in the Commission's earlier brief in this appeal, the judgment of the district court should be affirmed.

Respectfully submitted,

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