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 Appeal From the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

The Securities and Exchange Commission brought an enforcement action to protect the public by obtaining an injunction against the appellant from further violations of the antifraud and registration provisions of the federal securities laws.

The questions presented are:

1. Where the evidence showed that the appellant in fact exercised managerial and supervisory authority over a brokerage firm, and particularly that the appellant supervised the firm's salesmen and knew that salesmen were selling securities by means of false and misleading representations, can the appellant, by virtue of the fact that he did not have an official

title at the firm, escape liability for failing to take steps to stop the fraud?

2. (a) Must the Commission establish that the appellant's prior misconduct was accompanied by scienter--that is, intent to deceive, manipulate or defraud?

(b) Assuming, arguendo, that scienter is required, was the district court's finding that the appellant acted with scienter clearly erroneous when the record in this case established scienter by showing that the appellant knew of the falsity of the salesmen's representations or, when advised that those representations were false, acted in reckless disregard of their truth or falsity?

3. Where registration under the Securities Act for sales by a broker-dealer of certain securities to the public would be required if the person from whom the broker has purchased the securities is a controlling person of the issuing company, can the registration requirements lawfully be avoided by the broker's use of another broker, acting as an intermediary, to make it appear that the securities are being purchased from the other broker rather than from the controlling person?

4. In light of the findings of the district court that the appellant, who held managerial and supervisory responsibility at a brokerage firm, committed serious violations of the registration and antifraud provisions of the securities laws and that there was a likelihood of future violations, was it an abuse of discretion for the district court to enjoin the appellant from further violations of the registration and antifraud provisions?

STATUTES AND RULES INVOLVED

Sections 2(11), 4, 5(a), 5(c), 17(a) and 20(b) of the Securities Act of 1933, 15 U.S.C. 77b(11), d, e(a), e(c), q(a) and t(b), and Rule 144 thereunder, 17 CFR 230.144; and Sections 10(b) and 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), u(d) and Rule 10b-5 thereunder, 17 CFR 240.10b-5, are reprinted in the Statutory Appendix, pages 1a-12a infra.

COUNTERSTATEMENT OF THE CASE

Introduction

This is an appeal from a final judgment of permanent injunction entered, after trial, by the United States District Court for the Southern District of New York (Gagliardi, J.), on May 24, 1977, in an enforcement action brought by the Securities and Exchange Commission ("Commission") against the appellant and seven other defendants. 1/ Based upon findings that the appellant had violated the registration 2/ and antifraud 3/ provisions of the federal securities laws in connection with the offer and sale of the common stock of Lawn-A-Mat Chemical & Equipment Co. ("Lawn-A-Mat"), the district court enjoined the

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1/ These other defendants, who consented, without admitting or denying the the allegations of the Commission's complaint, to judgments of permanent injunction, are described in the text at p.4, infra, and in note 5, infra.

2/ Sections 5(a) and (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and 77e(c).

3/ 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 under the latter section, 17 CFR 240.10b-5.

appellant from committing further violations of these provisions (A. 824-826). 4/ The district court's opinion is unofficially reported as Securities and Exchange Commission v. E. L. Aaron & Co., et al., [Current] CCH Fed. Sec. L. Rep. ¶96,043 (S.D. N.Y., May 5, 1977).

The violations found by the district court were committed by the appellant, Peter Aaron, in the course of his employment by defendant E. L. Aaron & Co. ("Aaron & Co."), a broker-dealer registered with the Commission and having its principal office at 50 Broad Street in New York City (A. 2-3, 16).

The appellant's father, defendant Edward L. Aaron, was the president and sole shareholder of the brokerage firm. The appellant, who had been employed at the firm for approximately fifteen years (A. 391), served as his father's "assistant," and the firm's "trouble shooter" (A. 510, 556), and was the liaison among the firm's various departments--operations, sales, and the trading room (A. 393, 557-558).

In November, 1974, Aaron & Co. opened a branch office on Long Island, in Roslyn, New York. Defendant Norman Schreiber, a salesman at the firm's principal office in New York City, transferred to the branch office (A. 458). Defendant Donald Jacobson, another salesman, also worked at the Roslyn office (A. 458, 645).

4/ "A. ___" refers to pages of the Joint Appendix. "Br. ___" refers to pages of the brief of the appellant.

The district court found that the appellant had functioned in a managerial and supervisory capacity at Aaron & Co., and had permitted Schreiber and Jacobson to sell Lawn-A-Mat stock by means of representations which the appellant knew to be false, and, in so doing, had aided and abetted violations of the antifraud provisions of the federal securities laws. In addition, the court found that the appellant had participated in the sale, by Aaron & Co., of unregistered Lawn-A-Mat stock to the firm's customers in violation of the registration provisions of the Securities Act of 1933.

The Proceedings Below

The Commission instituted this action on February 26, 1976, pursuant to Section 20(b) of the Securities Act of 1933, 15 U.S.C. 77t(b), and Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 77u(d). The complaint, alleging violations of the registration and antifraud provisions of those Acts, named the appellant and seven others as defendants. 5/

Final judgments of permanent injunction by consent were entered against all defendants except the appellant. After a trial on the charges against the appellant, the district court issued findings

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5/ All eight defendants were charged with having violated the antifraud provisions of the securities laws in connection with the offer and sale of Lawn-A-Mat stock. In addition to the five defendants already identified in the text (the appellant Peter Aaron, Edward L. Aaron, Aaron & Co., Schreiber, and Jacobson), the remaining defendants were Lawn-A-Mat, a New York corporation engaged in the business of selling franchises and products for lawn care, whose stock is registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act (A. 3, 16); Daniel Dorfman, a director and principal stockholder and, until May, 1975, president of Lawn-A-Mat; and Fernando Erazo, a director, chief operating officer and, at various times, president and executive vice president of Lawn-A-Mat.

The defendants charged with violating the registration provisions were the appellant, Aaron & Co., Edward L. Aaron, and Norman Schreiber.

of fact and conclusions of law and thereafter issued the injunctive order from which this appeal has been taken.

The Fraud Violations--False and Misleading Statements in Connection with the Offer and Sale of Lawn-A-Mat Securities

In November, 1974, Schreiber obtained authorization from either Edward or Peter Aaron (or both of them) for Aaron & Co. to become a "market maker" in Lawn-A-Mat common stock (A. 805, 413)--that is, for Aaron & Co. to hold itself out as being willing to buy and sell Lawn-A-Mat stock for its own account on a continuous basis. 6/ Thereafter, Schreiber and Jacobson continuously solicited customer orders to purchase Lawn-A-Mat stock (A. 805, 424, 498).

Aaron & Co. obtained lists of Lawn-A-Mat's shareholders at the time it began to make a market in Lawn-A-Mat securities (A. 805, 464-468). Schreiber and Jacobson used the lists to solicit, over the telephone and through the mails, purchases of Lawn-A-Mat stock (A. 805). Between November, 1974, and August, 1975, they engaged in an intensive sales campaign, soliciting more than 200, and perhaps as many as 1,000, potential investors (A. 497-498). They sometimes called potential purchasers repeatedly in successive weeks (A. 107-108), or every month (A. 150), in an effort to persuade those individuals to purchase Lawn-A-Mat securities.

Schreiber and Jacobson told prospective investors, among other things, that

(a) Lawn-A-Mat was planning to manufacture, or was in the process of manufacturing, tractors and a new type of automobile (an electric car with a fiberglass

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6/ See definition of the term "market maker" in Section 3(a)(38) of the Securities Exchange Act, 15 U.S.C. 78c(a)(38).

body) together with a Japanese company (A. 806, 106-108, 116-117, 134, 149, 164, 673-687, 662);

(b) the price of Lawn-A-Mat stock would increase several times from its current price (A. 806, 117, 118, 147-148, 692-699, 674, 661);

(c) Lawn-A-Mat would have $5 million in sales in 1975 and $25 million in 5 years and its earnings were increasing (A. 806, 165-166, 174), and the company would shortly pay dividends (A. 668); and

(d) Lawn-A-Mat was about to acquire a chemical factory—in order to manufacture its own chemicals (A. 174, 668-669)--and other companies (A. 668, 672-673).

The evidence in the court below showed that each of these statements was materially false. Thus, Lawn-A-Mat was not planning to manufacture, nor was it in the process of manufacturing, tractors or any type of automobile (A. 806, 183, 185, 189, 205, 276-279, 318, 381, 510). And, the company did not own, nor was it about to acquire, any other companies (A. 184, 277, 318-319). Moreover, there was no basis upon which to project that the price of Lawn-A-Mat stock would increase several times from its current price (A. 806, 749-799), or that Lawn-A-Mat would experience any increase in sales (A. 806, 85, 278-279, 381, 384). In fact, Lawn-A-Mat's most recent financial statements, available to the defendants at the time of their fraudulent statements, showed that Lawn-

A-Mat was losing money (A. 806, 185, 278, 319, 749-799) and was not financially capable of paying any dividends (A. 185, 380, 319). 7/

Lawn-A-Mat became aware, in January, 1975, that these misrepresentations were being made when the president of the company began to receive complaints from persons who had bought Lawn-A-Mat stock from Aaron & Co. (A. 272-273). Representatives of Lawn-A-Mat—including Nina Lane, the secretary to the president of Lawn-A-Mat, and Milton Kean, counsel for Lawn-A-Mat--repeatedly advised the defendant Schreiber—who had been identified by the complainants as one of the persons making the misrepresentations, and who was the manager of Aaron & Co.'s Roslyn branch office (A. 458) -- of the misleading nature of these representations and told him to stop making them (A. 293, 485, 486). Nevertheless, both Schreiber and Jacobson continued to make the misrepresentations (A. 501).

Subsequently, in April, 1975, Kean called Aaron & Co. to complain about Schreiber's and Jacobson's continuing misrepresentations (A. 274). Upon being referred to the appellant, Kean told him that Schreiber and Jacobson "were giving uncorrect [sic] statements to dealers, distributors or stockholders of the company" regarding the financial condition of Lawn-A-Mat and the manufacture by Lawn-A-Mat of a car, and that "it would have to be stopped" (A. 274, 275, 426). Kean advised the appellant that those statements were not true and were not supported by Lawn-A-Mat's most recent filings with the Commission (A. 426). 8/

7/ Lawn-A-Mat's financial condition deteriorated to the point where, on January 23, 1976, Lawn-A-Mat filed for an arrangement under Chapter XI of the Bankruptcy Act, 11 U.S.C. 701 et seq., in the United States District Court for the Eastern District of New York (A. 267-268, 362).

8/ The appellant was responsible for the maintenance of Aaron & Co.'s "due diligence" files, which contained up-to-date financial information

(footnote continued)

The appellant assured Kean that "he would talk to them" and that he would have Schreiber and Jacobson "discontinue their activities in Lawn-A-Mat stock" (A. 274, 275, 426). But, in response to Kean's call, the appellant merely called Jacobson--and not Schreiber, the manager of the branch office—and told Jacobson to "talk to Kean" and "take care of it" (A. 274, 426).

Several months after Kean first called the appellant, Kean again called him and complained that Schreiber and Jacobson were continuing to make the same misrepresentations concerning Lawn-A-Mat (A. 182-183, 276, 428, 519). The appellant again promised that he would "talk to the Long Island people" (A. 428), but, again, he merely called the Roslyn office (where Schreiber and Jacobson worked) about the complaint (A. 428). Although the appellant may have talked to his father about the complaints after receiving the second call from Kean (A. 434), he did not take any steps, effective or otherwise, to stop the misrepresentations. Indeed, the appellant never directed Schreiber or Jacobson to discontinue making misrepresentations concerning Lawn-A-Mat (A. 639).

In light of the foregoing, the district court found first that Schreiber and Jacobson had knowingly and intentionally continued to solicit purchases of Lawn-A-Mat stock by means of false or misleading statements concerning that company (A. 810, 429).

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8 / (footnote continued)

tion including the most recent filings with the Commission by the companies in whose securities Aaron & Co. made a market (A. 392). The court below found (Op. 12) that, as the individual responsible for the maintenance of these files, the appellant, even apart from what he had had been told by Kean, had reason to know that Lawn-A-Mat was not planning to embark on the production of automobiles, and that its financial position was not improving but was deteriorating (see. A. 749-799).

In the court below, the appellant sought to escape responsibility for these violations by asserting that, regardless of whether he had known of the fraudulent activity of Schreiber or Jacobson, he had no supervisory responsibility over them and, therefore, could not be held liable for their misrepresentations. The district court rejected these assertions, finding (A. 810, 803-804), on the basis of the evidence as more fully set forth in the Argument portion of this brief, infra, that the appellant

> "functioned in a managerial and supervisory capacity over all the activities at Aaron & Co. In particular, he supervised the registered representatives and received and answered complaints about their activities."

The court found (A. 807) that, despite his supervisory responsibility over Schreiber and Jacobson, the appellant "did nothing to stop or correct the false or misleading" representations. It concluded (A. 812, citation omitted) that the appellant,

> "by virtue of his active participation in the management of the firm and his knowledge both of the firm's solicitation of Lawn-A-Mat stock and the false and misleading statements being made by Schreiber and Jacobson in connection with that solicitation, must be held responsible for the fraudulent misrepresentations that were made,"

and held (id., citations and footnote omitted) that,

> "[w]hile Peter Aaron himself did not make any misrepresentations, by failing to stop Schreiber and Jacobson, he wilfully aided and abetted their violations of the anti-fraud provisions of the securities laws."

The Registration Violations--The Offer and Sale of Unregistered Lawn-A-Mat Securities

In November, 1974, Schreiber called Daniel Dorfman, who at that time was the President, a director, and the principal stockholder of Lawn-A-Mat,

to solicit a sale by Dorfman of Lawn-A-Mat common stock (A. 323). Dorfman eventually agreed to sell 1,000 shares (A. 316-317).

Because Dorfman was a controlling person of Lawn-A-Mat, the sale of his shares through Aaron & Co. into the market would, in the absence of registration of those shares under the Securities Act, violate the Act's registration provisions unless the sale was made in accordance with the terms of Commission Rule 144, 17 CFR 230.144. 9/ Rule 144 permits the sale into the market of limited amounts of unregistered securities by a controlling person if the sales are made in compliance with the various conditions set forth in the rule, including a requirement that the broker executing the sale not solicit customer orders to buy the securities in connection with the transaction. Since Aaron & Co. was a market-maker in Lawn-A-Mat stock (see page 5, supra), and thus was continuously soliciting purchases of the stock, a sale of Dorfman's stock into the market through Aaron & Co. as the selling broker could not satisfy the requirements of Rule 144. Accordingly, Schreiber and the appellant arranged to have another brokerage firm ostensibly sell Daniel Dorfman's shares into the market so that the sale would appear to comply with Rule 144, when in fact the shares were sold into the market by Aaron & Co. in violation of the registration provisions.

9/ Rule 144 is designed to implement the fundamental purpose of the Securities Act as described in the Act's Preamble—to provide full and fair disclosure of the character of securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof. The rule is designed to prohibit the creation of public markets in securities where adequate current information about the issuer of the securities is not available to the public. Where such information is available, the rule, among other things, permits the sale in the market of limited amounts of unregistered securities by controlling persons. See the Preliminary Note to Rule 144, 17 CFR 230.144.

See also Sections 2(11), 4(1), and 5 of the Securities Act, 15 U.S.C. 77b(11), d(1) and e.

This transaction was arranged in the following manner: The appellant told an Aaron & Co. employee, Lawrence Firrincielli, to contact J. W. Weller & Co., Inc. ("Weller"), a New Jersey broker-dealer, to see if that firm would be interested in "crossing" certain trades with Aaron & Co. (A. 656-657). Under that arrangement, Aaron & Co. would purchase Lawn-A-Mat stock from controlling persons of Lawn-A-Mat through Weller, which would purportedly act as the selling shareholders' "agent" in the transactions (A. 656-657, 66, 417, 808). The plan was that Aaron & Co. would appear to have purchased the stock in the market, would thus not be regarded as acting for a controlling person in subsequently reselling the stock, and would therefore be free to sell the stock to the public without registration.

In carrying out this plan, the appellant and Schreiber determined the sales price of Dorfman's stock and the amount of the "commission" that Weller would receive as compensation for its participation (A. 656-658). Weller agreed to the arrangement, and the transaction was consummated, Daniel Dorfman selling his 1000 shares to Aaron & Co., —at 27 cents per share, for a total of $2700—and Weller receiving, as compensation for acting as intermediary, a $20 "commission" (A. 347).

Schreiber sent Daniel Dorfman a blank Form 144, 10/ to be completed and approved by his attorney, Milton Kean. Kean returned the completed form to Aaron & Co. (A. 268-269, 745-748).

In February, 1975, Schreiber similarly contacted another controlling person of Lawn-A-Mat, Fred Dorfman, who was vice president and

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10/ Under subsection (h) of Rule 144, the selling shareholder is required to file with the Commission a notice of sale on Form 144. 17 CFR 230.144(h).

a director of Lawn-A-Mat. Schreiber solicited the sale of 20,000 shares of unregistered Lawn-A-Mat common stock from Fred Dorfman to Aaron & Co. (A. 80, 91, 554). Again, pursuant to the arrangement which the appellant had made with Weller, Schreiber directed Fred Dorfman, who had never heard of Weller prior to this transaction, to deliver to Weller the securities to be sold (A. 86). The securities were then transferred to Aaron & Co. (A. 739-744).

The 21,000 shares of Lawn-A-Mat stock purchased by Aaron & Co. from the Dorfmans were resold by Aaron & Co. to the public (A. 739-744) without the benefit of registration under the Securities Act.

The district court, stating (A. 815, footnote omitted) that "Weller & Co.'s participation in the transaction was a sham to evade the intent of * * * Rule [144] while feigning technical compliance," concluded (A. 816) that the appellant "violated and aided and abetted violations of" the registration provisions of the Securities Act.

ARGUMENT

I. THE DISTRICT COURT PROPERLY FOUND THAT THE APPELLANT PARTICIPATED IN VIOLATIONS OF THE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

A. False Representations About Lawn-A-Mat Were Made By Aaron & Co. Employees to the Firm's Customers.

As described previously (pages 6-7, supra), Schreiber and Jacobson engaged in an extensive sales campaign in Lawn-A-Mat stock, during which they made serious and blatant misrepresentations to numerous Aaron & Co. customers concerning various aspects of Lawn-A-Mat's activities and financial condition. The appellant does not dispute that these representations were actually made. And, with one exception, he does not dispute that the representations were false. The one exception

(discussed in detail infra pp. 15-17,) is the representation regarding Lawn-A-Mat's supposed plans to build a car and a tractor (Br. 17-27). By ignoring the other misrepresentations which were made to investors, the appellant seeks to minimize the seriousness of the fraud perpetrated on investors by persons subject to his supervision.

With respect to these other misrepresentations, for example, Stanley Gordon (a Lawn-A-Mat shareholder) received numerous telephone calls from Schreiber and Jacobson soliciting purchases of additional Lawn-A-Mat stock (A. 670-671). In those calls, they represented, among other things, that the stock would go up in price between 50 and 100 times in the succeeding five years (A. 690). And, at a time when the stock was trading at 25 cents a share, Schreiber offered to sell shares of Lawn-A-Mat to Eliezer Strauss, a Lawn-A-Mat dealer, at $1 a share, stating (A. 670-671) that the price would go up to over a dollar, that Strauss would be "stupid" if he did not buy immediately (A. 670-671), that Lawn-A-Mat would start paying dividends in about a year, and that Lawn-A-Mat would eventually build or acquire a chemical plant (A. 672-673).

As illustrated by these examples, and more fully documented by the other record references cited earlier (pages 6-7, supra), the fraud here involved was a serious matter, even apart from the representations about the car and the tractor. Price predictions, such as those made by Schreiber and Jacobson here, are a "hallmark of fraud." Alexander Reid & Co., Inc., 40 S.E.C. 986, 991 (1962). And, the Commission has repeatedly held that predictions of a specific and substantial price increase within a relatively short time are inherently fraudulent and cannot be justified. 11/

11/ See, e.g., Koss Securities Corp., Securities Exchange Act Release No. 34-11580 (Aug. 8, 1975), 7 SEC Docket 550, 551 n. 5; Kennedy,

(continued)

In any event, the record clearly establishes the falsity of the statements made by Schreiber and Jacobson concerning the development of a new car and tractor by Lawn-A-Mat. The district court's findings of falsity are supported by the unequivocal testimony of Lawn-A-Mat's president, Fernando Erazo, and its counsel, Milton Kean, that, contrary to Schreiber's and Jacobson's representations, Lawn-A-Mat was neither manufacturing nor planning to manufacture a car or a tractor (A. 183, 185, 276, 278-279). In his opening brief (Br. 18-27), the appellant argues that representations about Lawn-A-Mat's future plans to develop a car and tractor were supported by testimony given by Daniel Dorfman, at one time the president of Lawn-A-Mat. While, as we show below, Dorfman's testimony was not inconsistent with the testimony of Erazo and Kean, even if it were, the district court was entitled to credit the testimony of Erazo 12/ and Kean, and accordingly, the court's findings are not

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11/ (footnote continued)

Cabot & Co., Inc., 44 S.E.C. 216, 222 (1970); James De Mammos, 43 S.E.C. 333, 336 (1967), affirmed without opinion, C.A. 2, Docket No. 31469 (Oct. 13, 1969); R. Baruch & Co., 43 S.E.C. 13, 18 (1966); Underhill Securities Corp., 42 S.E.C. 689, 693 (1965); Aircraft Dynamics International Corp., 41 S.E.C. 566, 570 (1963). And, this Court has also recognized the fradulent nature of such predictions. Hanly v. Securities and Exchange Commission, 415 F.2d 589, 593 (C.A. 2, 1969); cf. Hiller v. Securities and Exchange Commission, 429 F.2d 856, (C.A. 2, 1970); United States v. Wolfson, 405 F.2d 779, 785 (C.A. 2, 1968) certiorari denied, 394 U.S. 946 (1969).

12/ Erazo was hired as executive vice-president and chief operating officer of Lawn-A-Mat in October, 1974, and replaced Daniel Dorfman as president of Lawn-A-Mat in May, 1975 (A. 178-179). In this connection, Daniel Dorfman testified that, between October 1, 1974, and December 15, 1975, he had no "day-to-day contact with the company" (A. 382) and that Erazo, as chief operating officer, had "complete authority" (A. 380).

"clearly erroneous," the test under Rule 52(a) of the Federal Rules of Civil Procedure. 13/

While the Erazo and Kean testimony is dispositive of this issue, an examination of the testimony of Dorfman shows that even his testimony is not, as the appellant contends, inconsistent with the court's findings of falsity. Dorfman testified that, while he owned stock in another company, United Stellar Corporation, and that company was planning to build a car or tractor, Lawn-A-Mat had no such plans (A. 319-320).

In February, 1975, Lawn-A-Mat had acquired, through Dorfman, an option to buy stock in United Stellar (A. 328-329, 343). Dorfman testified that it was his intention that Lawn-A-Mat would derive the benefit in the event that an automobile was ultimately produced by United Stellar (A. 328). While Dorfman stated that this was his intention, he further testified that Lawn-A-Mat itself never seriously considered exercising its option to purchase United Stellar stock (A. 382, 385).

13/ See Zenith Radio Corp. v. Hazeltine Research, Inc., 395 U.S. 100, 123 (1969), where the Court stated (citations omitted):

> "In applying the clearly erroneous standard to the findings of a district court sitting without a jury, appellate courts must constantly have in mind that their function is not to decide factual issues de novo. The authority of an appellate court, when reviewing the findings of a judge as well as those of a jury, is circumscribed by the deference it must give to decisions of the trier of the fact, who is usually in a superior position to appraise and weigh the evidence. The question for the appellate court under Rule 52(a) is not whether it would have made the findings the trial court did, but whether 'on the entire evidence [it] is left with the definite and firm conviction that a mistake has been committed.' United States v. United States Gypsum, 333 U.S. 364, 395 (1948)."

Notwithstanding Dorfman's stock interest in Lawn-A-Mat, he was not in a position at that time to see to it that his intention would be carried out by Lawn-A-Mat since Erazo had assumed authority over the company and Dorfman had no day-to-day contact with the company. See note 12 supra. 14/

Finally, assuming arguendo that Dorfman's testimony could be construed to mean that Lawn-A-Mat had planned to manufacture an automobile, the fact remains that Schreiber and Jacobson not only made representations to potential customers that Lawn-A-Mat had such plans, but that they also made representations that Lawn-A-Mat was actually engaged in the process of manufacturing automobiles. Dorfman's testimony in no way supports the truth of the latter representations. Indeed, since Lawn-A-Mat only held an unexercised option to purchase stock in United Steller, it is clear that Lawn-A-Mat could not have been so engaged.

B. The Evidence Fully Supports The District Court's Finding That The Appellant Participated in Violations Of The Antifraud Provisions.

The appellant contends (Br. 10) that, because he did not have an official title at Aaron & Co., there was no basis upon which the district court could find him liable for aiding and abetting the fraudulent conduct of Schreiber and Jacobson. He does not dispute that managerial or supervisory personnel who hold appropriate titles at a brokerage firm have responsibility to take steps to prevent or stop violations of the federal securities laws by the firm's employees. With respect to persons exercising managerial functions, this Court so recognized in Gross v. Securities and Exchange Commission, 418 F.2d 103 (C.A.

14/ It appears that there was a struggle between Dorfman and Erazo and a group of distributors, for control of Lawn-A-Mat (A. 379-383).

2, 1969). Thus, in affirming a decision rendered by the Commission in an administrative proceeding, this Court stated (id. at 107 (emphasis added)), with respect to a vice-president of a brokerage firm:

> "On the basis of [the appellant's] participation in the management of the firm and his knowledge of the course of conduct in which his firm was engaging * * *, the Commission could have concluded that he 'aided and abetted' activities of the firm which were found to be in violation of the federal securities law anti-fraud provisions."

It has likewise been recognized that individuals with supervisory responsibility over employees at brokerage firms have a duty to "exercise the utmost vigilance whenever a remote indication of irregularity reaches their attention." Sutro Bros. & Co., 41 S.E.C. 443, 463 (1963) (footnote omitted); Reynolds & Co., 39 S.E.C. 903, 916 (1960); see also, Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 847 (E.D. Va., 1968) (private action).

The appellant's contention that his lack of a formal title relieves him of the responsibilities imposed on managerial and supervisory personnel elevates form over substance, and its adoption would severely undermine the purposes of the federal securities laws. It would deprive customers of brokerage firms of the protections which they are entitled to expect and receive when dealing with professionals in the securities industry. Neither the Commission nor the courts have permitted such a result. Thus, in Gross v. Securities and Exchange Commission, supra, this Court focused, not upon the petitioner's status as a brokerage firm officer, but rather upon his "participation in the management of the firm * * *." 418 F.2d at 107. And, other cases have held that persons performing managerial functions in brokerage firms have a duty to take steps to ensure the firm's compliance with the federal securities laws, even though they hold no official positions in the firms. See, e.g.,

Securities and Exchange Commission v. E. J. Albanese & Co., [1976-1977 Decision] CCH Fed. Sec. L. Rep. ¶ 95,778 (S.D. N.Y., 1976); Samuel A. Sardinia, [1975-1976 Decision] CCH Fed. Sec. L. Rep. ¶ 80,501 (S.E.C., 1976); cf. Securities and Exchange Commission v. Galaxy Foods Inc., 417 F. Supp. 1225, 1246 (E.D. N.Y., 1976), affirmed from the bench, 556 F.2d 559 (C.A. 2, 1977), certiorari denied sub nom. Kirschenblatt v. Securities and Exchange Commission, 98 S. Ct. 175 (Oct. 3, 1977).

Even in a situation where liability is specifically placed, by statute, on an "officer" of a corporation, this Court has held that the absence of an official title does not preclude liability. See, e.g., Colby v. Klune, 178 F.2d 872 (C.A. 2, 1949). In that case, this Court stated, with respect to Section 16(b) of the Securities Exchange Act, 15 U.S.C. 78p(b) (which allows an issuer of securities to recover, from certain of its insiders, profits earned from short-term trading in its securities), that the term "'officer,' as used in Section 16(b)," is to be interpreted in light of the duties which a corporate employee performs, and that "[i]t is immaterial how his functions are labelled * * *." 178 F.2d at 873. Cf. Wolf v. Weinstein, 372 U.S. 633, 648-652 (1963).

Thus, notwithstanding the fact that the appellant did not have an official title at Aaron & Co., the district court's findings that the appellant aided and abetted violations of the antifraud provisions are warranted on either of two grounds. First, the court found that the appellant had managerial responsibility at Aaron & Co., and knew that Schreiber and Jacobson were making fraudulent representations concerning Lawn-A-Mat, but took no action to stop that conduct (Op. 13). These findings are sufficient grounds to hold the appellant "'responsible * * * for the fraudulent representations that were made.'" Gross v. Securities and Exchange Commission, supra, 418 F.2d at 106.

Second, the court's findings that the appellant exercised supervisory responsibility over the firm's salesmen and other employees (A. 804), but failed to take steps, after Kean's complaints, to stop Schreiber and Jacobson from continuing to make misrepresentations about Lawn-A-Mat (A. 807, 812), also will support the district court's holding that the appellant aided and abetted violations of the antifraud provisions. See pages 17-18, supra.

These holdings are supported by uncontested evidence which establishes the great extent to which the appellant participated in the management of Aaron & Co. and performed supervisory functions. Contrary to the appellant's assertion (Br. 11)—that the evidence adduced at trial was "vague and general testimony"—most of the supporting evidence is specific and detailed, and consists of the appellant's own trial testimony. Despite the absence of any formal title, the appellant, who had begun working at the firm at the age of 16 "to find out what made his father's firm tick" (A. 448), acted as "the assistant to the president" (A. 401 (Aplt.)). 15/ The evidence shows that, in this capacity, he exercised responsibilities, and received compensation, comparable to that of his father, Edward L. Aaron, the president of Aaron & Co.

Thus, only the appellant and his father hired employees (A. 252, 399-400 (Aplt.)) and exercised supervisory authority over the firm's salesmen (A. 253, 257, 556, 655). 16/ Only the appellant and his father had authority to sign the firm's checks (A. 408 (Aplt.)). Only the

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15/ The term "Aplt" refers to testimony of the appellant.

16/ From October, 1974, to August, 1975, the period during which the violations took place, Aaron & Co. had as many as 50 employees, including 25 full-time and 15 part-time salesmen (A. 451).

appellant and his father distributed bonus checks to employees (A. 257), and only the two of them had authority to cancel payment on commission checks made out to an employee in the event that his customer failed to pay for the securities involved (A. 61). And, while his father spent most of the day trading securities and executing orders in the trading room (A. 253, 410 (Aplt.)), the appellant acted as a one-man "liaison" among all of the departments within the firm — including the trading room (A. 392 (Aplt.), 504) — and assisted his father there (A. 599-600).

The appellant was also responsible for handling offerings of new issues and private placements in which the firm participated (A. 60, 392 (Aplt.)). He also handled the "legal aspects" of sales of securities pursuant to Rule 144 (A. 255). Moreover, the appellant was the firm's "troubleshooter" (A. 508, 556), in charge of resolving the firm's day-to-day problems and ensuring the smooth operation of the firm (A. 508, 556, 583-584). In this capacity, the appellant would, in the first instance, handle customer complaints (A. 558).

Indeed, in the present case, when Kean called Aaron & Co. to complain about Schreiber's and Jacobson's continued misrepresentations concerning Lawn-A-Mat, he was referred to the appellant (A. 288-289). The appellant held himself out as having supervisory responsibility over Schreiber and Jacobson by assuring Kean that he would talk to them and that they would discontinue their activities in Lawn-A-Mat stock, see page 8-9, supra.

The appellant was also responsible for the maintenance of the firm's "due diligence" files which contained financial information, including the most recent statements filed with the Commission, on all securities

in which Aaron & Co. made markets (A. 392 (Aplt.)). As part of his supervisory duties over the firm's salesmen, he would oversee the market-making activities of the salesmen by "monitoring" the amount of securities any salesman was permitted to purchase for the firm's account (A. 401 (Aplt.)). And, at the end of every month, the appellant, sometimes with his father, would discuss with each salesman the salesman's production figures for that month in relation to those of the firm's other salesmen (A. 398 (Aplt.), 255). The appellant also conducted sales meetings about twice a month for the firm's salesmen during which he discussed sales techniques and often gave "pep talks" (A. 255, 411-412 (Aplt.)). 17/

In return for his activities, the appellant received compensation which he characterized as "comparable" to that of his father (A. 397 (Aplt.)) — a weekly paycheck ranging from $200 to $300, and paid expenses totaling about $1,000 a month (A. 396 (Aplt.)). The firm also paid both the appellant's and his father's personal rents and telephone bills (id.). Just as the appellant had inherited from his mother a note for a $50,000 subordinated loan to the firm (A. 397 (Aplt.)), 18/ the appellant

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17/ The appellant erroneously asserts (Br. 5) that "many employees at Aaron & Co. testified that he had no supervisory responsibility or duties at Aaron & Co." But, the employees' testimony cited in the appellant's brief does not so state. First, the appellant cites his own testimony, wherein he outlined his managerial and supervisory responsibilities at the firm that are discussed supra, pp. 20-22. The employees testified only that they personally had dealt, for various reasons, directly with Edward L. Aaron. Nevertheless, they also did testify that the appellant's general duties at the firm were those outlined on pp. 20-22, supra (A. 446, 503-506, 510, 514, 515, 546-547).

18/ The note was the only subordinated debt which the firm had (A. 397 (Aplt.)). The appellant inherited the note several years prior to the period when the violations here involved were committed (A. 397 (Aplt.)), and it was paid in July, 1975, the month preceding the end of that period and only a few months prior to closing of the firm (A. 397-398 (Aplt.)).

expected that one day he would inherit the firm from his father (A. 255 (Aplt.)).

The appellant claims (Br. 13-16) that, even if he did have managerial and supervisory authority at Aaron & Co., his authority extended only to the firm's main office and, therefore, he could not be held responsible with respect to violations committed by Schreiber and Jacobson since they worked at the firm's branch office and were, therefore, purportedly outside of the appellant's sphere of responsibility. The appellant states (Br. 16), in an attempt to illustrate his contention, that violations committed in a San Francisco branch office of Merrill Lynch, Pierce, Fenner and Smith, Inc. would not result in the issuance of an injunction against personnel located at the firm's branch office in Miami.

The appellant's illustration is not in point. The appropriate example would relate to the responsibility, not of personnel in another branch office, but rather of personnel at a firm's main office who have general managerial or supervisory roles in the firm. Contrary to the appellant's further assertion (Br. 16) that "top level management" personnel of a firm which has branch offices are not responsible under the securities laws for branch office activities except in "strange and unusual circumstances," a firm's general managerial and supervisory personnel are required to exercise continuing supervision over the activities of both the main and the branch offices. Securities and Exchange Commission v. Charles A. Morris & Associates, Inc., [1972-1973 Decisions] CCH Fed. Sec. L. Rep. ¶ 93,756 at pp. 93,301, 93,306 (W.D. Tenn., 1973); Reynolds & Co., supra, 39 S.E.C. at 916-917; see also Dunhill Securities Corp., 44 S.E.C. 472, 476 (1971); Sutro Bros. & Co., supra, 41 S.E.C. at 459-463 (1963).

In any event, the duty of the appellant here to take steps to prevent and stop violations occurring at his firm's branch office does not rest solely on his general managerial role in the firm since he actually did perform supervisory functions with respect to the firm's branch office. As we have shown (pages 21-22, supra), the appellant, among other things, monitored the firm's market-making activities--activities which included the market-making in Lawn-A-Mat stock by Schreiber and Jacobson at the branch office (see page 22, supra).

Moreover, the appellant's claim that Schreiber ran the branch office without any supervision over him or the branch office by the appellant is negated by the evidence of the appellant's general responsibility for handling complaints of the firm's customers and, in particular, by the appellant's own statements to Kean, in response to Kean's complaints about Schreiber's and Jacobson's misrepresentations, indicating that he had supervisory responsibility over Schreiber and Jacobson (see page 21, supra).

Indeed, if Schreiber in fact had sole supervisory authority over the branch office, the appellant, in conveying Kean's complaints to that office, would have--and should have--spoken directly to Schreiber instead of telling salesman Jacobson to call Kean and take care of the matter. The appellant's claim (Br. 14,15) that Jacobson was supervised solely by the branch office manager, Schreiber, and not by the appellant, is further negated by Jacobson's testimony that he was in constant communication with the appellant concerning his sales activities in Lawn-A-Mat stock (A. 649-653).

The appellant's duty under the federal securities laws to prevent or stop violations occurring at his firm does not, as he contends (Br.

13), depend upon whether he was registered with the National Association of Securities Dealers ("NASD") as a principal or anything else. Brokerage firm personnel who, like the appellant, are not registered with the NASD as principals, are nevertheless subject to the supervisory and managerial duties imposed under the federal securities laws. Just as the appellant cannot avoid these responsibilities by virtue of his lack of an official title in his firm, so too he cannot avoid these responsibilities by failing to register with the NASD as a principal.

Finally, although the appellant attributes great significance to the fact that he was not registered as a principal with the NASD, the fact is that he deliberately failed to register with the NASD as a principal of Aaron & Co. in an attempt to insulate himself from any adverse effects which might flow from any enforcement action, such as the present case, brought by the Commission against Aaron & Co. (A. 437). 19/

C. "Scienter" is not an element of a claim for relief in a Commission injunctive action to enforce the antifraud provisions of the federal securities laws.

The appellant asserts as error the entry of an injunction under the antifraud provisions in the claimed absence of proof that he acted

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19/ The district court properly excluded letters dated August, 1971, between Daniel Brescher, attorney for Aaron & Co., and the NASD, as irrelevant to the issue of whether the appellant aided or abetted violations of the antifraud provisions of the federal securities laws. The letter from Brescher to the NASD purportedly set forth the activities engaged in by the appellant at Aaron & Co. and requested the opinion of the NASD, based upon the representations made therein, as to whether the appellant should register as a principal. The letter from the NASD purportedly stated that, under the circumstances set forth in the Brescher letter, the appellant did not have to register as a principal. Since the NASD's opinion was based on the self-serving statements made by the appellant in his counsel's letter in order to obtain the NASD's opinion, that opinion is of little probative value. Moreover, the exchange of letters took place three years before the period during which the violations occurred, and the letters were, in the court's view, too remote in time to cast light on the extent of the appellant's responsibilities at the time of the violations (A. 553).

with scienter (Br. 39-42). The district court, in response to the appellant's contention that scienter was required to be shown in Commission enforcement actions, concluded that "negligence alone may suffice as a standard for liability in Commission enforcement actions" (A. 812, citations omitted), but that, in any event, the facts showed that the appellant's conduct in connection with the false and misleading statements was "sufficient to establish his scienter under the securities laws" (A. 813, citations omitted). In Part D, infra, we show that the district court correctly concluded that the appellant acted with scienter, and in this Part we show that the district was also correct in concluding that scienter was not required.

1. A Showing of Scienter Is Not Required in a Commission Injunctive Action.

The appellant's argument that scienter is required in this case is based on Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), where the Supreme Court held that scienter--defined by the Court to mean "a mental state embracing intent to deceive, manipulate, or defraud" (id. at 193 n. 12)--is a necessary element of "a private cause of action for damages" under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder (id. at 193, emphasis supplied). The Court in Hochfelder, however, specifically declined to address the question whether scienter is also required in an action, like the present case, which is brought by the Commission to obtain equitable relief (id. at 193 n. 12).

Unlike a Rule 10b-5 private damage action, which is a "judicially" created implied right of action and thus may be "judicially delimited," 20/

20/ Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975).

this Commission enforcement action was brought pursuant to the statutory authorization in Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), and Section 21(d) of the Securities Exchange Act, 15 U.S.C. 78u(d). These sections do not require the Commission to prove, or the court to find, that a past violation occurred in order for an injunction to issue; 21/ rather, it is sufficient that the Commission make a "proper showing" that a person is engaged, or is about to engage, in conduct which violates the Acts.

Moreover, when Congress intended to require, in a government action, a certain state of mind on behalf of the defendant, it knew how to say so. Contrast Sections 20(b) and 21(d) in this respect with Sections 15(b)(4) and (6) of the Securities Exchange Act, 15 U.S.C. 78o(b)(4) and (6), which require that the Commission, in order to impose a disciplinary sanction upon a person in the securities business, find that he "willfully" violated the law. 22/ Also compare Sections 20(b) and 21(d) with Section 24 of the Securities Act, 15 U.S.C. 77x, and Section 32(a) of the Securities Exchange Act, 15 U.S.C. 78ff(a),

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21/ A finding of past violation, however, is often important, since an inference that future violations will be committed may be drawn from such a finding. See pp. 52 - 53, infra.

22/ Even in such a disciplinary administrative proceeding, the requirement that the violation be "willful"

> "'does not require proof of evil motive, or intent to violate the law, or knowledge that the law was being violated * * *. All that is required is proof that the broker-dealer acted intentionally in the sense that he was aware of what he was doing.' 2 Loss, Securities Regulation 1309 (1961). This view has been accorded judicial acceptance * * *. Tager v. Securities Exchange Commission, 344 F.2d 5, 8 (2 Cir. 1965)."

Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 180 (C.A. 2, 1976), certiorari denied, 46 U.S.L.W. 3432 (Jan. 10, 1978).

which similarly require that, in order to sustain a criminal conviction for violation of those Acts' provisions, the conduct be "willful." 23/

As the Court of Appeals for the First Circuit aptly observed, in holding that Hochfelder is not applicable to a Commission injunctive action:

> "From the standpoint of an SEC injunction against violations which the court finds are likely to persist, a defendant's state of mind is irrelevant. If proposed conduct is objectively within the Congressional definition of injurious to the public, good faith, however much it may be a defense to a private suit for past actions, see Ernst & Ernst v. Hochfelder * * *, should make no difference. Cf. SEC v. Capital Gains Research Bureau, Inc., [375 U.S. 180 (1963)]."

Securities and Exchange Commission v. World Radio Mission, 544 F. 2d 535, 540 (C.A. 1, 1976). World Radio Mission, like the instant case, involved both violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder and violations of Section 17(a) of the Securities Act.

In Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180 (1963)—cited in the foregoing quotation from World Radio Mission—the Supreme Court held, in a Commission injunctive action, that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages," id. at 193, and further stated (id. at 200):

"To impose upon the Securities and Exchange Commission

23/ The courts have defined the requirement that criminal conduct be "willful" in a manner similar to the definition of that requirement for sanctioning a securities broker-dealer by the Commission—that it is sufficient that the actor intended to do the act, and not that he also knew that he was violating the law. See United States v. Charnay, 537 F.2d 341, 351-352 (C.A. 9), certiorari denied, ____ U.S. _____, 97 S. Ct. 528 (1976); Arthur Lipper Corp. v. Securities and Exchange Commission, supra, 547 F.2d at 181 n. 7.

> the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute."

Significantly, Capital Gains was referred to by the Supreme Court in Hochfelder when it noted that different standards of conduct might apply in actions for equitable relief than in private damage actions. 24/ Therefore, Hochfelder does not restrict the application of the Supreme Court's earlier holding in Capital Gains.

World Radio Mission pointed out (544 F. 2d at 540-541) that this Court had "correctly anticipated the Hochfelder outcome and required proof of scienter in private damage actions under Rule 10b-5, see, e.g., Lanza v. Drexel & Co., 2 Cir., 1973, 479 F. 2d 1277, [but did not consider] intent relevant SEC injunction actions, see, e.g., SEC v. Shapiro, 2 Cir., 1974, 494 F. 2d 1301, 1308." Both cited cases, Lanza and Shapiro, involved violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5. In the former case, a private action for damages, this Court held that some element of scienter was required, 25/ while in the latter, an injunctive action brought by the Commission, this Court reaffirmed its prior holdings as to the applicability of the negligence standard.

24/ There the Court stated, 425 U.S. at 193 n. 12:

> "Since this case concerns an action for damages we * * * need not consider the question whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5. Cf. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)."

25/ See also the discussion in Judge Friendly's concurring opinion in Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-868 (C.A. 2, 1968), certiorari denied, sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969).

The repeated decisions of this Court holding that negligence is the proper standard in Commission actions for equitable relief 26/ are consistent with numerous decisions of other courts of appeals and of district courts. 27/

Although this Court has not yet rendered any holding--since Hochfelder--on the question whether scienter is a necessary element in a Commission injunctive action charging a violation of Rule 10b-5, this Court has expressed views on that question by way of dictum. See Arthur Lipper Corporation v. Securities and Exchange Commission, 547 F.2d 171 (1976), certiorari denied, 46 U.S.L.W. 3432 (Jan. 10, 1978); Securities and Exchange Commission v. Universal Major Industries, 546 F.2d 1044 (1976).

Lipper involved a finding of violation of Rule 10b-5, but in an administrative proceeding (in which the Commission imposed a disciplinary

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26/ See Securities and Exchange Commission v. Management Dynamics, Inc. 515 F.2d 801 (1975); Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (1973); Securities and Exchange Commission v. Everest Management Corp., 475 F.2d 1236, 1240 (1972); Securities and Exchange Commission v. North American Research & Development Corp., 424 F.2d 63 (1970); Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F. 2d at 863.

27/ See Securities and Exchange Commission v. Dolnick, 501 F.2d 1279, 1284 (C.A. 7, 1974); Securities and Exchange Commission v. Pearson, 426 F.2d 1339, 1343 n. 4 (C.A. 10, 1970); Securities and Exchange Commission v. Van Horn, 371 F.2d 181, 186 (C.A. 7, 1966); Securities and Exchange Commission v. Geotek, 426 F. Supp 715, 726 (N.D. Cal., 1976) appeal pending, C.A. 9 No. 77-1768; Securities and Exchange Commission v. Trans Jersey Bancorp, [1976-1977] CCH Fed. Sec L. Rep. ¶95,818 (D. N.J., 1976). Contra, Securities and Exchange Commission v. Coffey, 493 F.2d 1304 (C.A. 6, 1974), certiorari denied, 420 U.S. 908 (1975); Securities and Exchange Commission v. Bausch and Lomb Inc., 420 F. Supp 1226 (S.D. N.Y., 1976), affirmed on other grounds, [Current] CCH Fed. Sec. L. Rep. ¶96,186 (C.A. 2, Sept. 30, 1977); Securities and Exchange Commission v. Cenco, Inc., [Current] CCH Fed. Sec. L. Rep. ¶96,133 (N.D. Ill., July 28, 1977), petition by Commission for rehearing pending; Securities and Exchange Commission v. Southwest Coal & Energy Co, [Current] CCH Fed. Sec. L. Rep. ¶ 96,257 (W.D. La., Nov. 8, 1977); Securities and Exchange Commission v. American Realty Trust, 429 F. Supp. 1148 (E.D. Va., 1977), appeal pending, C.A. 4, No. 77-1839. And see Securities and Exchange Commission v. Lummis, [Current] CCH Fed. Sec. L. Rep. ¶ 96,245 (N.D. Cal., Nov. 22, 1977).

sanction against a broker-dealer) rather than in an injunctive action. Stating that such disciplinary administrative proceedings "share with damage suits the quality of visiting serious consequences on past conduct," this Court went on to "assume, arguendo, without deciding, that the Hochfelder culpability standard applies in disciplinary proceedings." 547 F.2d at 180 n. 6. 28/ Significantly, however, the Court suggested the appropriateness of not requiring scienter in injunctive proceedings, emphasizing that their "objective * * * is solely to prevent threatened future harm * * *." Id.

The Universal Major Industries case, like the present case, was a Commission injunctive action, but it involved violations of the Securities Act's registration provisions rather than violations of its fraud provisions. This Court there stated (546 F.2d at 1047) that its pre-Hochfelder decisions had

> "made it clear that in SEC proceedings seeking equitable relief, a cause of action may be predicated upon negligence alone, and scienter is not required."

While noting that not every court had agreed with that rule, this Court emphasized (id., footnote omitted):

> "[I]t is nonetheless the law of this Circuit. Hochfelder, which was a private suit for damages, does not undermine our prior holdings."

Although Universal Major Industries involved only registration violations, the Court's explicit statement that negligence is a sufficient predicate for a Commission action for equitable relief was made without qualification and

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28/ But see the Commission's decisions in Shaw, Hooker & Co., Securities Exchange Act of 1934 Release No. 14289 (Dec. 19, 1977), 13 SEC Docket 1171, 1173 n. 9; Steadman Security Corp., [Current] CCH Fed. Sec. L. Rep. ¶81,243 at p. 88,339 n. 10 (S.E.C., 1977) petition for review pending, C.A. 5, No. 77-2415.

thus was not limited to registration violations. Furthermore, one of the pre-Hochfelder decisions which this Court mentioned in Universal Major Industries as not having been undermined by Hochfelder was Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (1973), a decision in which this Court recognized that it had "enunciated the negligence test principally in cases involving the anti-fraud provisions of the securities laws * * *." Id. at 541 n. 12. 29/

The Hochfelder holding reflected the Supreme Court's concern that a negligence standard, as opposed to a scienter standard, in the case of an implied private right of action for damages would both disrupt the statutory scheme of the carefully drawn "express civil remedies" in the Securities Act and the Securities Exchange Act 30/ and "significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions

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29/ In Buchman v. Securities and Exchange Commission, 553 F.2d 816, 821 (1977), an appeal to this Court from an order of the Commission which had sustained disciplinary action taken by the National Association of Securities Dealers, Inc. ("NASD") against NASD members for violation of its Rules of Fair Practice, this Court held that "[a] breach of contract is unethical conduct in violation of NASD Rules only if it is in bad faith, just as conduct violates Rule 10b-5 only if there is scienter * * * [citing Hochfelder]." Rule 10b-5 was not involved in Buchman, and it is not clear what the reference to Hochfelder was intended to suggest. Five months later, this Court, in Securities and Exchange Commission v. Bausch & Lomb Inc., [Current] CCH Fed. Sec. L. Rep. ¶ 96,186 at p. 92,350 (Sept. 30, 1977), was presented with the same question involved in the present case--whether proof of scienter is required in a Commission injunctive action charging a violation of Rule 10b-5. The Court decided the Bausch & Lomb case, however, on other grounds, without reaching that question. In doing so, the Court stated (id.), "We need not now decide whether Hochfelder mandates abandonment of our long-standing rule that proof of past negligence will suffice to sustain an SEC injunction action."

30/ 425 U.S. at 200-201.

with respect to matters under the Acts," 31/ with the consequent spectre of "liability in an indeterminate amount for an indeterminate time to an indeterminate class." 32/ Such concerns, while relevant to an implied private damage action such as Hochfelder, are inapplicable to the instant Commission enforcement action for equitable relief, which, as we have noted (page 5, supra) was instituted pursuant to express statutory authority. 33/ The distinction between private damages actions and Commission actions was noted by Congress in 1975, when it adopted the Securities Acts Amendments of 1975, P.L. 94-29, 89 Stat. 97 (June 4, 1975):

> "Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to matters of damages, such as scienter, causation, and the extent of damages, are elements not required to be demonstrated in a Commission injunctive action" (citation omitted, emphasis in original). 34/

In Commission actions "all that must be established is what the statute requires, without reference to proof of irreparable injury or

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31/ Id. at 214 n. 33.

32/ Id. at 215 n. 33, quoting Ultramares Corp. v. Touche, 255 N.Y. 170, 179-180, 174 N.E. 441, 444 (1931).

33/ See S. Rep. No. 75, 94 Cong., 1st Sess. 76 (1975), where the Senate Committee on Housing, Banking and Urban Affairs stated that,

> "although both the Commission's suit for injunctive relief brought pursuant to express statutory authority and a private action for damages fall within the general category of civil (as distinct from criminal) proceedings, their objectives are really very different. Private actions for damages seek to adjudicate a private controversy between citizens; the Commission's action for civil injunction is a vital part of the Congressionally mandated scheme of law enforcement in the securities area."

34/ Id. at 76.

the inadequacy of other remedies as in the usual suit for injunction." 35/ Indeed, it has long been settled in this Circuit that the standards which govern the issuance of an injunction authorized by statute are less strict than those applicable in private litigation, 36/ and that, in such cases, "the standards of the public interest not the requirements of private litigation measure the propriety and need for injunctive relief." 37/ In actions seeking injunctions to protect the public from future violations of the federal securities laws, 38/ the Commission appears "not as an ordinary litigant, but as a statutory guardian charged

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35/ 3 L. Loss, Securities Regulation 1979 (2d ed., 1961) (footnotes omitted). Unlike private plaintiffs, if the Commission is denied relief, it has no remedy at law which it might choose to pursue.

36/ See, e.g., Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 808; Henderson v. Burd, 133 F.2d 515, 517 (C.A. 2, 1943); Securities and Exchange Commission v. Jones, 85 F.2d 17 (C.A. 2), certiorari denied, 299 U.S. 581 (1936).

37/ Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944), quoted with approval in Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 808-809. Compare Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 57-59 (1975); Sonesta International Hotels Corp. v. Wellington Associates, 483 F.2d 247, 250 (C.A. 2, 1973).

38/ See Securities and Exchange Commission v. World Radio Mission, Inc., supra, 544 F.2d at 541; Securities and Exchange Commission v. Trans Jersey Bancorp, supra, [1976-1977 Decisions] CCH Fed. Sec. L. Rep. ¶95,818; Securities and Exchange Commission v. F.L. Salomon, [1975-1976 Decisions] CCH Fed. Sec. L. Rep. ¶95,335 (S.D.N.Y., 1975); Securities and Exchange Commission v. Golconda Mining Co., 327 F.Supp. 257 (S.D.N.Y., 1971). In Securities and Exchange Commission v. Petrofunds, 420 F.Supp. 958, 960, n. 6 (S.D.N.Y., 1976), appeal dismissed with prejudice, No. 76-6184 (C.A. 2, 1977), Judge Weinfeld remarked:

> "Indeed, Congress has recently passed legislation significantly increasing the SEC's powers to regulate in the public interest see Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 * * *, and in doing so repeatedly emphasized the special status of the SEC as a protector of the public interest. S. Rep. 75, 94th Cong., 1st Sess. 1 passim."

with safeguarding the public interest in enforcing the securities laws." 39/ Unlike the plaintiff in a private damage action, the Commission is not suing to vindicate its own rights or interests; rather it seeks only to protect the public interest and the interests of investors from future violation of those laws. Further, the injunctive relief sought by the Commission, which "can be of such great public benefit and do so little harm to legitimate activity," 40/ serves only as a "mild prophylactic" 41/ and simply requires the defendant to obey the securities laws in the future. 42/ It "is designed to protect the public against conduct, not to punish a state of mind." 43/

To summarize, Commission injunctive actions, which are prospective in nature, seek relief designed to protect public investors from future violations of the federal securities laws—violations which will have the same adverse impact on the public regardless of the defendant's state of mind or intentions. Private damage actions, on the other hand, are retrospective only, and are intended to provide monetary redress to the plaintiff, and often others similarly situated, for past violative conduct. Accordingly, a scienter requirement in Commission actions,

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39/ Securities and Exchange Commission v. Management Dynamics Inc., supra, 515 F.2d at 808.

40/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, 401 F.2d at 868 (Friendly, J. concurring).

41/ Securities and Exhchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 193.

42/ See Securities and Exchange Commission v. Graye, 156 F.Supp. 544, 547 (S.D.N.Y., 1957) (Kaufman, J.); cf. Mitchell v. Pidcock 299 F.2d 281, 287 (C.A. 5, 1962).

43/ Securities and Exchange Commission v. World Radio Mission, Inc., supra, 544 F.2d at 541 (footnote omitted).

and the resulting difficulty in proving a defendant's state of mind, would serve to hamper, not further, the broad remedial purposes of the federal securities laws. 44/ We respectfully submit that the negligence standard consistently applied by this Court in Commission injunctive actions is the only appropriate standard.

2. Regardless of Whether a Showing of Scienter is Required in a Commission Injunctive Action Under Section 10(b) of the Securities Exchange Act and Rule 10b-5, Scienter Is Not Required in an Action Under Section 17(a) of the Securities Act.

Even if the Commission were required in injunctive actions to prove scienter to establish a violation of the antifraud provisions of Rule 10b-5, it is plain that a showing of scienter would not be required under the similar antifraud provisions of Section 17(a) of the Securities Act. Since the Commission in this action alleged, and the district court held (Op. 10-14) that the appellant's fraudulent conduct violated both Rule 10b-5 and Section 17(a), Section 17(a) provides an independent basis for affirming the district court's findings of fraud violations.

The reasoning which was used by the Supreme Court in Hochfelder to require scienter under Rule 10b-5 supports the opposite result under Section 17(a). In holding that scienter was required under Rule 10b-5, the Supreme Court relied not on the language of the Rule (which is almost identical to Section 17(a)), but rather on the language of the statutory provision--Section 10(b)--pursuant to which Rule 10b-5 was adopted.

44/ The Supreme Court has repeatedly emphasized that the federal securities laws should be construed broadly and flexibily to effectuate their remedial purposes. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 475-476 (1977); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 195.

Even if the language of the Rule, when read in isolation from the statute, could be read to prohibit merely negligent conduct, the Court reasoned that Section 10(b)'s use of the words "manipulative," "deceptive," and "device or contrivance"--words which the Court viewed as suggesting "knowing or intentional misconduct"—precluded an interpretation of Rule 10b-5 which did not require scienter. 425 U.S. at 197. That reasoning would not have a like result in the case of Section 17(a), at least with respect to certain of Section 17(a)'s subsections. The three subsections of Section 17(a) are almost identical to the three subsections of Rule 10b-5. With respect to subsections (2) and (3) of Section 17(a), it is significant that the Supreme Court in Hochfelder recognized that the corresponding subsections--(b) and (c)--of Rule 10b-5 may be read as not requiring scienter. The Court stated, 425 U.S. at 212 (emphasis supplied):

> "The Commission contends, however, that subsections (b) and (c) of Rule 10b-5 are cast in language which—if standing alone--could encompass both intentional and negligent behavior. These subsections respectively provide that it is unlawful '[t]o make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . .' and '[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . .' Viewed in isolation the language of subsection (b), and arguably that of subsection (c), could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not".

The above-quoted language of the Supreme Court in Hochfelder affirmatively supports the proposition that subsections (2) and (3) of Section Section 17(a) could be violated by negligent conduct. And, since Section

17(a) is a statute, rather than a Commission rule--the scope of which is limited by its enabling statutory provision--the Hochfelder analysis which limited the scope of Rule 10b-5 cannot be applicable here.

The Court of Appeals for the First Circuit came to this conclusion in Securities and Exchange Commission v. World Radio Mission, supra, 544 F.2d at 541 n. 10. The Court there stated:

> "Defendants engage in a technical argument, that since the language of section 17(a) of the 1933 act is virtually identical to that of Rule 10b-5, and since Hochfelder read section 10(b) of the 1934 act, under which Rule 10b-5 was promulgated, as requiring scienter, section 17(a) must be similarly interpreted. This is a non sequitur. The Hochfelder Court recognized that Rule 10b-5(2), making it unlawful 'to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,' is not, by itself, limited to intentional deceit; but the Court held that the rule, if so interpreted, would exceed the authority of section 10(b) of the statute. 425 U.S. at 212-214 * * *. Section 17(a), however, is a congressional enactment, not an SEC rule, and it contains the same language which the Hochfelder Court recognized did not require scienter. Thus, strictly speaking, since this action is founded on both section 17(a) and Rule 10b-5, we need not decide what result would obtain in an SEC injunction action based solely on section 10(b) and Rule 10b-5—though we do think it implausible to suppose that Congress intended to provide a mechanism for the SEC to protect the public from the injurious schemes of those of evil intent and yet leave the public prey to the same conduct perpetrated by the careless or reckless."

Thus, we believe it is quite clear that, regardless of whether the scienter requirement enunciated in Hochfelder is applicable to Commission injunctive actions under Section 10(b) and Rule 10b-5, the scienter standard does not apply to cases brought under Section 17(a) of the Securities Act. 45/ As the Court of Appeals for the Seventh Circuit remarked in

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45/ As a contemporaneous comment on Section 17 stated, that Section "makes unlawful even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts." Douglas & Bates, "The Federal Securities Act of 1933," 43 Yale L.J. 171, 181 (footnote omitted) (1933).

Securities and Exchange Commission v. Van Horn, 371 F.2d 181, 185 (1966), in holding that a Commission action under Section 17(a) did not require a showing of scienter:

> "In view of the plain language employed by Congress, it would be presumptuous on our part to hold that the applicability of the clauses involved [Section 17(a)(2) and (3)] is dependent on intent to defraud." 46/

This result is in accord with the Supreme Court's recognition in Capital Gains, supra, 375 U.S. at 200, that language similar to that in Section 17(a) does not require the Commission to show "deliberate

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46/ See also, Swanson v. American Consumers Industries, Inc., 475 F.2d 516, 525 n. 6 (C.A. 7, 1973). But see Sanders v. John Nuveen & Co., 554 F.2d 790, 795-796 (1977), a private action, where the Court of Appeals for the Seventh Circuit, without mention of its prior holding in Securities and Exchange Commission v. Van Horn, supra, stated that it was "persuaded" that clauses (1) and (3) of Section 17(a) require scienter because the term "fraud" appears in both of those clauses. With respect to clause (2), the court indicated that scienter is not required by the language of that clause. It concluded, however, that, because of the interplay between express and implied private rights of action, scienter would be required in a private action under the clause.

Several district courts have also dealt, since Hochfelder, with the question whether scienter is required under Section 17(a). In Securities and Exchange Commission v. Southwest Coal & Energy Co., [Current] CCH Fed. Sec. L. Rep. ¶ 96,257, at p. 92,700 (W.D. La., Nov. 8, 1977), appeal pending, C.A. 5, No. 78-1130, the court held scienter not to be an element of a claim for relief under Section 17(a)(2) but suggested that Section 17(a)(1) would require a showing of scienter. The district court in Securities and Exchange Commission v. American Realty Trust, supra, 429 F. Supp. at 1171, found Section 17(a) to be indistinguishable from Rule 10b-5 and, on that basis, held that scienter was required under Section 17(a). And see, Securities and Exchange Commission v. Lummis, supra, [Current] CCH Fed. Sec. L. Rep. ¶ 96,245 at p. 92,637-92,638. See also, Malik v. Universal Resources Corp., [Current] CCH Fed. Sec. L. Rep. ¶ 96,055, p. 91,756 (S.D. Cal., Jun. 3, 1976), where the Court held scienter to be required in a private action implied under Section 17(a) to avoid conflict with the express private remedies in the federal securities laws.

dishonesty as a condition precedent to protecting investors * * *." Although Capital Gains was brought under the Investment Advisers Act of 1940, 15 U.S.C. 80b, rather than the Securities Act, the antifraud section of that Act contains provisions which are virtually identical to clauses (1) and (3) of Section 17(a). 47/

D. Even Assuming That Scienter is Required to be Shown in This Commission Injunctive Action, the District Court Held, and the Record Demonstrates, that the Appellant Acted with Scienter.

As noted earlier (page 26, supra), the district court, although holding that scienter was not required, found that the appellant acted with scienter (A. 812-813). The court found that the appellant knew the representations being made by Schreiber and Jacobson to be false and that he deliberately failed to stop them (A. 813). The appellant challenges that finding, asserting that he actually believed that the representations being made by Schreiber and Jacobson regarding Lawn-A-Mat's supposed plans to build a car were true. 48/

47/ Section 206 of the Investment Advisers Act, which was involved in the Capital Gains case, is quoted in the opinion of that case, 375 U.S. at 181-182 n. 2. Clauses (1) and (2) of that section use language virtually identical to language contained in clauses (1) and (3) of Section 17(a) of the Securities Act. Thus, clause (1) of the Advisers Act section makes it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client" and clause (2) makes it unlawful for him "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The Investment Advisers Act has no language comparable to clause (2) of Section 17(a) of the Securities Act, which reads "to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." This additional language in Section 17(a)(2) would seem to make the Section 17(a) case for liability based on negligence a fortiori because there is nothing in that subsection to suggest even remotely the necessity for scienter or any form of knowing conduct.

48 / Implicit in this argument is, of course, a concession that the appellant knew of the representations and that in spite of warnings

(footnote continued)

Appellant thus limits his lack-of-scienter argument to the misrepresentations concerning manufacture of a car and does not attempt to assert a belief in the other statements being made, including statements concerning Lawn-A-Mat's prospective financial fortunes and the prospect for a rise in the price of the stock. 49/

The appellant argues (Br. 44) only that, in failing to take action to stop the sales campaign being conducted by Schreiber and Jacobson, he justifiably relied upon statements supposedly made to him by Daniel Dorfman about plans of Lawn-A-Mat to manufacture a car. The district court, however, found (A. 806, 822 n. 7) that Dorfman's statements about plans to build a car were always in terms of his own intentions, not Lawn-A-Mat's. This finding is not clearly erroneous (See A. 329-335).

In any event, Dorfman's statements upon which the appellant claims to have relied were apparently made at a meeting (Br. 44) which took place in late 1974 (A. 324, 462, 518), approximately four months before Kean's first telephone call to the appellant (April, 1975) to ask that the misrepresentations be stopped (see A. 274-275). The appellant suggests that he continued to believe what Dorfman is claimed to have said at the meeting despite the passage of time and the obvious conflict between Dorfman's version of the facts and that of Kean. The district court, as trier of fact, did not credit the appellant's supposed belief in Dorfman's

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48/ (footnote continued)

from representatives of Lawn-A-Mat, he did not act to stop them. See in this regard, Jacobson's testimony regarding one of the telephone calls from the appellant to the brokerage firm's branch office to relay Lawn-A-Mat's complaints. Jacobson testified that when he told the appellant that the statements he and Schreiber were making to investors had come from Dorfman, the appellant said only "okay" (A. 637-639, 652-653; see also id. at 642-643).

49/ Accordingly, the district court's conclusion (see A. 810-812) that the appellant participated in Schreiber's and Jacobson's, fraudulent activity in this regard is not disputed.

version (A. 806-807, 813). Faced with the supposedly differing Kean and Dorfman versions, the appellant hardly had a convincing basis to support his claimed belief in Dorfman on an economic issue of the magnitude of whether a company like Lawn-A-Mat, which made no mention of it in its public reports, was about to enter the automobile business, in potential competition with General Motors, Ford Motor Company, Chrysler Corporation and American Motors.

The fact that the appellant's alleged belief was not reasonable in view of the information available to him, including the brokerage firm's due diligence files, is ample support for the district court's finding (A. 813) to the effect that there was no such belief. 50/ Accordingly, the district court's finding that the appellant acted with scienter is fully supported by the record. 51/

Nonetheless, even if one were to credit the appellant's alleged belief in Lawn-A-Mat's prospects for becoming a car manufacturer, his conduct would still satisfy the scienter standard. As the Supreme Court indicated in Hochfelder, 52/ and as has long been recognized, 53/ statements made in reckless disregard for their truth or falsity

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50/ Cf. Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 (C.A. 2, 1972); United States v. Benjamin, 328 F.2d 854 (C.A. 2, 1964); United States v. White, 124 F.2d 181, 185 (C.A. 2, 1941); Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441, 447, 449-450 (1931).

51/ The appellant's brief (Br. 44) also conveys the impression that subsequent to the April telephone call from Kean he attended a second meeting and investigated the conflicting Kean and Dorfman stories. The record reference cited there, at n. 77, relates, however, to the meeting with Dorfman the previous December (see A. 324, 462, 518).

52/ 425 U.S. at 193-194 n. 12.

53/ See, e.g., Prosser, Law of Torts, 701 (4th Ed., 1971); Lanza v. Drexel, 479 F.2d 1277, 1306 (C.A. 2, 1973).

are sufficient to establish scienter. 54/ This Court has said

> "In determining what constitutes 'willful or reckless disregard for the truth' the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or 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. Chris Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363-364, 396-399 (2d Cir. 1973). The answer to the inquiry will of course depend upon the circumstances of the particular case, including the nature and duties of the corporate positions held by the defendants."

Lanza v. Drexel, 479 F.2d 1277, 1306 n. 98 (C.A. 2, 1973).

Just as this Court stated that it is a proper inquiry to examine the responsibilities of the corporate defendants in Lanza, it is proper to stress that the appellant here, and the salesmen he supervised, were professionals in the securities business. It has long been recognized under the federal securities laws that a securities professional has a duty not to

> "recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation."

54/ In Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 472 (1977), the Supreme Court described its holding in Hochfelder as being that "a cause of action under Rule 10b-5 does not lie for mere negligence." (Emphasis supplied.) As Judge Weinfeld noted in Steinberg v. Carey, 439 F. Supp. 1233, 1238 (S.D.N.Y., 1977), there is "virtual unanimity * * * since Hochfelder that reckless conduct meets the scienter standard" under Rule 10b-5. See, cases cited id. at 1238 n. 15.

Hanly v. Securities and Exchange Commission, 415 F.2d 589, 598 (C.A. 2, 1969). 55/

In the "circumstances of * * * [this] particular case," Lanza v. Drexel, supra, 479 F.2d at 1306 n. 98, the appellant's conduct was at least reckless. The appellant failed to make inquiry after having been told by Kean that the statements being made by Schreiber and Jacobson were false. That the appellant could have "apprise[d] [himself] of the facts * * * without any extraordinary effort" (id.) seems clear from the record. Lawn-A-Mat's public filings were in appellant's due diligence files, but apparently were not consulted (A. 406-407). And, for all that appears in the record, Dorfman (cf. A. 476, 486) and members of the management of Lawn-A-Mat were accessible. But there is no suggestion in the record that the appellant made any attempt to resolve the supposedly conflicting versions of the facts. Instead, he permitted Schreiber and Jacobson to continue recommending Lawn-A-Mat stock through representations which Kean had advised him were false and with no disclosure to the firm's customers of conflicting information.

Finally, the appellant contends (Br. 44, 51) that Schreiber and Jacobson lacked scienter and, therefore, that there were no underlying violations which he can be held to have aided and abetted. But, even assuming, arguendo, that scienter is required in this injunctive action and that Schreiber and Jacobson lacked the requisite scienter, the

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55/ Accord, Kahn v. Securities and Exchange Commission, 297 F.2d 112, 114-115 (C.A. 2, 1961) (Clark, J. concurring); Charles Hughes & Co. v. Securities and Exchange Commission, 139 F.2d 434, 436-437 (C.A. 2, 1943) certiorari denied, 321 U.S. 786 (1944). See generally, 3 Loss, Securities Regulation, 1482-1497 (2 ed. 1961).

appellant may not, on that basis, escape his own responsibility. At a minimum, liability of a participant in a transaction which violates the federal securities laws may be premised on a showing of his own "knowledge of the fraud" and his failure to act to prevent it. See Hirsch v. du Pont, 553 F.2d 750, 759 (C.A. 2, 1977). 56/ And, as we have shown (supra, pages 9, 41-42), the appellant had such knowledge. If a person knows that his subordinates are making false statements, it makes no difference that the subordinates believe what they are saying. 57/

56/ See also Murphy v. McDonnell & Co., 553 F.2d 292, 295 (C.A. 2,1977); Lanza v. Drexel & Co., supra, 479 F.2d at 1302.

57/ In any event, it appears that Schreiber and Jacobson had acted with scienter. They had extensive contacts with persons associated with Lawn-A-Mat (see generally A. 601-653) and became aware of the struggle for control within Lawn-A-Mat (A. 625-626, 382-383). In effect, by relying upon Dorfman's story of plans to build a car, they chose sides in the struggle, and could properly be held to have proceeded at their peril. The fact that they supposedly chose to believe that Dorfman's own vague plans to build a car for Lawn-A-Mat would be put into effect, where this proved not to be so, and ignored the other side does not aid them or the appellant. At the very least they should have tempered their enthusiasm for Lawn-A-Mat's supposed plans to build a car, with disclosure to their customers of conflicting information they had. See Hanly v. Securities and Exchange Commission, 415 F.2d 589, 597 (C.A. 2, 1969).

II. THE DISTRICT COURT PROPERLY FOUND THAT THE APPELLANT VIOLATED THE REGISTRATION PROVISIONS OF THE SECURITIES ACT.

A. The Sales by Aaron & Co. To Its Customers of Unregistered Lawn-A-Mat Stock Were Not Exempt from the Registration Requirements of the Securities Act.

The registration provisions of the Securities Act were intended to assure that, when securities move from the issuing company, or from a controlling person of that company, through a brokerage firm into the market, the members of the public who acquire the securities from the brokerage firm receive the protections afforded by registration. These protections include the disclosures made in a registration statement filed with the Commission and in a prospectus delivered to the investors. 58/ To accomplish this purpose, the Act provides, in Section 5, that it is unlawful to offer or sell, through the mails or in interstate commerce, any unregistered securities.

Through the exemptive provisions in Section 4, however, sales by ordinary persons, as opposed to sales by the issuer or controlling persons, are exempted from registration. Specifically, Section 4 exempts transactions not involving the issuer or an "underwriter," the latter term essentially encompassing persons (such as brokerage firms) who act as intermediaries between the issuer or controlling person and the public. One type of such intermediary is any person who purchases the securities from a controlling person with a view toward reselling them (see Section 2(11) of the Act).

In the present case, the district court found (A. 816) that "Aaron and Co. effectively purchased the [Lawn-A-Mat] stock directly from the Dorfmans," who were controlling persons of Lawn-A-Mat (see pages 9-13

58/ See Gilligan, Will & Co. v. Securities and Exchange Commission, 267 F.2d 461, 463 (C.A. 2), certiorari denied, 361 U.S. 896 (1959).

supra). Since Aaron and Co. made these purchases with a view toward reselling the stock to the public, Aaron and Co. was an "underwriter," and accordingly its resales were not exempt from registration. Thus, the Court held, Aaron and Co's resales were made in violation of Section 5 of the Securities Act.

With respect to these sales, it is undisputed that, if Aaron and Co. had purchased the stock from the Dorfmans without interposing another brokerage firm, Weller, in the transaction, Aaron and Co. would be an underwriter and therefore not entitled to resell the stock in the absence of registration. To permit Aaron and Co. to avoid the registration requirements by the simple device of placing Weller in the middle of the transaction, pursuant to a prearranged agreement to transfer the stock to Aaron and Co., would undermine the statutory purpose of affording the protections of registration when securities move from a controlling person into the market. The district court recognized that Weller's "participation in the transaction was a sham * * *"(A. 815). It would elevate form over substance to permit this sham transaction to control the availability of the registration protections. Accordingly, Aaron & Co.'s sales of Lawn-A-Mat stock to the public were made in violation of Section 5 of the Securities Act.

The appellant's entire argument seeks to obscure the sham nature of the transaction he engineered. Thus, his argument that he did not violate Section 5 focuses solely on the sales of Lawn-A-Mat stock by the Dorfmans, through Weller, to Aaron and Co. and ignores the subsequent sales by Aaron and Co. to the public. As a result, the appellant discusses at length the question whether there was an exemption from registration for the former sales, thereby diverting attention from the critical transactions--Aaron and Co.'s sales of unregistered Lawn-A-Mat stock to the public.

B. The Appellant Violated the Registration Provisions by Virtue of His Participation in the Sale of Unregistered Lawn-A-Mat Stock to Aaron & Co's Customers.

The appellant argues (Br. 45) that, notwithstanding his participation in Aaron & Co.'s sales of unregistered Lawn-A-Mat stock, he did not act with scienter and accordingly did not violate the registration provisions.

As previously discussed (pages 25-40, supra), a finding of scienter is not required in injunctive proceedings brought by the Commission. Moreover, even if scienter were required in Commission proceedings, scienter is a concept which has relevance only to charges of fraud and can have no applicability to violations of the registration provisions. Scienter, defined by the Supreme Court as an "intent to deceive, manipulate, or defraud," 59/ refers to knowledge of a statement's falsity or reckless disregard for its truth. 60/ Since deception, manipulation, fraud or false misrepresentations are not among the elements of a violation of the registration provisions, scienter has no application in the context of those provisions.

Furthermore, the appellant's argument of lack of scienter as to the registration violations erroneously assumes that scienter relates to a person's knowledge of the meaning of the law. The appellant's argument (Br. 45-46) is that he acted in reliance on the advice of counsel that the transactions here involved did not violate the registration requirements. As already noted, however, scienter relates to knowledge or reckless disregard as to a statement's truth or falsity. That scienter does not relate to knowledge

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59/ Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 193-194 n. 12.

60/ Id. at 194 n. 12.

of the law was recognized by this Court in Arthur Lipper Corp. v. Securities and Exchange Commission, supra, 547 F.2d at 181, where it was stated:

> "The Court [in Hochfelder] held that * * * there must be proof of intention, 'to deceive, manipulate, or defraud' — not an intention to do this in knowing violation of the law."

See also Tager v. Securities and Exchange Commission, 344 F.2d 5, 8 (C.A. 2, 1965); United States v. Charnay, supra, 537 F.2d at 352.

While reliance on advice of counsel as to the lawfulness of a transaction is thus irrelevant to whether a violation of the registration provisions has been committed, it may be relevant to the issue of the appropriateness of granting injunctive relief once a violation has been found. Securities and Exchange Commission v. Manor Nursing Centers, 458 F.2d 1082, 1101 (C.A. 2, 1972). But, even where a court is asked to consider a defendant's good faith reliance on counsel in determining whether to grant injunctive relief, such reliance may be considered only where the defendant, in obtaining advice of counsel, has informed his counsel of all the relevant facts concerning the proposed transaction. Securities and Exchange Commission v. Senex Corp., 399 F.Supp. 497, 507 (E.D. Ky., 1975), affirmed, 534 F.2d 1240 (C.A. 6, 1976). And, contrary to the appellant's novel assertion (Br. 45) that reliance on advice of counsel is a valid defense "even if the advice is not followed," the courts have uniformly required that the opinion of counsel be followed. Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F.2d at 1101-1102; Securities and Exchange Commission v. Harwyn Industries Corp., 326 F.Supp. 943, 956-957 (S.D.N.Y., 1971); United States v. Hill, 298 F.Supp. 1221, 1235 (D. Conn., 1969).

In the present case, Daniel Brescher, counsel for Aaron & Co., testified that he never advised the appellant or anyone else at Aaron & Co. that it would be permissible, in the type of situation here involved,

to arrange for a customer to sell his unregistered stock through another broker with whom Aaron & Co. had an advance agreement to purchase the stock, and then to resell the stock to the public (A. 574).

Brescher's advice therefore did not address the transaction present in this case—where Aaron & Co. had a prearranged agreement to purchase the Dorfmans' stock through Weller. 61/ The court below correctly found (A. 817) that the appellant, in directing that an agreement be struck with Weller, "did not follow the opinion of counsel" and accordingly that "there was no reliance" on counsel.

III. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN ENJOINING THE APPELLANT FROM FUTURE VIOLATIONS OF THE REGISTRATION AND ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

In view of the appellant's admitted desire to return to the securities business (A. 818)--at the time of the trial he was in the field of commodity futures trading—and

> "[i]n light of the nature and the extent of the violations of the antifraud and registration provisions, [and] the defendant's failure to recognize the wrongful nature of his conduct,"

the district court concluded that there was a likelihood that the defendant would repeat his violative conduct (A. 818). The court determined, therefore, that it was in the public interest to issue an injunction (id.).

61/ We note that the appellant's reliance, in his brief (Br. 33-38), upon certain letters issued by the Commission's staff is similarly misplaced. These letters did not discuss the type of situation involved here—a prearranged agreement to purchase unregistered stock, through a strawman, for resale to the public.

This Court has stated in Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1100 (C.A. 2, 1972)(citations omitted):

> "In an action * * * where the SEC sought injunctive relief * * * a district court has broad discretion to enjoin possible future violations of law where past violations have been shown, and the court's determination that the public interest requires the imposition of a permanent restraint should not be disturbed on appeal unless there has been a clear abuse of discretion."

The burden is on the party seeking to overturn the district court's exercise of discretion, and the burden "necessarily is a heavy one." Id. 62/

The traditional equitable prerequisites to injunctive relief, including a showing of irreparable injury and inadequacy of legal remedies, 63/ are inapplicable where an agency enforces remedial legislation, such as the Securities Act and the Securities Exchange Act 64/ and seeks to enjoin possible future violations of law for the protection of the public. 65/ In Securities and Exchange Commission v. Management Dynamics, supra, this Court stated, 515 F.2d at 808-809:

> "[T]he SEC appears in these proceedings not as an ordinary litigant, but as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws. Hence, by making the showing required by statute that the defendant 'is engaged or about to engage' in illegal acts, the Commission is seeking to

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62/ See also, United States v. W. T. Grant, 345 U.S. 629, 633 (1953); Securities and Exchange Commission v. Culpepper, 270 F.2d 241, 250 (C.A. 2, 1959).

63/ See Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 60-61 (1975).

64/ See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6, 12 (1971); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

65/ Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

> protect the public interest, and 'the standard of the public interest, not the requirements of private litigation, measure the propriety and need for injunctive relief.' Hecht Co. v. Bowles, 321 U.S. at 331 * * * "

Once a determination has been made that a violation, or violations, have been committed, the "'critical question * * * is whether there is a reasonable likelihood that the wrong will be repeated.'" Securities and Exchange Commission v. Management Dynamics, supra, 515 F. 2d at 807 (citation omitted). 66/ Several factors are particularly relevant in determining whether there exists a reasonable likelihood of future violations. The courts, for example, have pointed out that such a likelihood may be inferred from past violations 67/ or from the fact that a defendant continues to maintain that his conduct was appropriate. 68/ In Securities and Exchange Commission v. First American Bank & Trust Company, 481 F.2d 673, 682 (C.A. 8, 1973), the court of appeals, in discussing the inference that past wrongs may give rise to the expectation of future misconduct, stated that the "inference is even stronger when the wrongdoers insist that their actions are legitimate and do not violate the Act."

66/ See also Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1100 (C.A. 2, 1972); Securities and Exchange Commission v. Culpepper, supra, 270 F. 2d at 249.

67/ Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 807; Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1308 (C.A. 2, 1974); Securities and Exchange Commission v. First American Bank & Trust Co., supra, 481 F.2d 673, 682 (C.A. 8, 1973); Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F.2d at 1100; Securities and Exchange Commission v. Keller Corp., 323 F.2d 397 (C.A. 7, 1963); Securities and Exchange Commission v. Culpepper, supra, 270 F.2d at 249-250; Securities and Exchange Commission v. J & B Industries, Inc., 388 F. Supp. 1082, 1084 (D. Mass., 1974); Securities and Exchange Commission v. M. A. Lundy Associates, 362 F. Supp. 226, 232 (D. R.I., 1973).

68/ Securities and Exchange Commission v. First American Bank & Trust Company, supra, 481 F.2d at 632; Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F.2d at 1100-1101; Securities and Exchange Commission v. MacElvain, 417 F.2d 1134, 1137 (C.A. 5, 1969), certiorari denied, 397 U.S. 972 (1970).

Contrary to the appellant's assertion (Br. 45) that his "unblemished 18 year record" in the securities business negates the likelihood of future violations, the district court could properly base its injunction upon its findings of past violations by the appellant.

Thus, the appellant permitted Schreiber and Jacobson to engage in fraudulent activities for about five months during which he had actual knowledge of the false and misleading representations they were making (see page 9, supra). While the appellant assured counsel for Lawn-A-Mat that he would stop Schreiber and Jacobson from making the misrepresentations, he took no steps to do so. Lawn-A-Mat stock continued to be sold to the public by means of false and misleading statements—including predictions that the price of Lawn-A-Mat stock would increase dramatically and that its sales would jump to $5 million in 1975 and to $25 million by 1980 (when actually the company was losing money), and false representations that Lawn-A-Mat was manufacturing or about to manufacture a new automobile and tractor. The district court found (A. 802, 804) on the basis of the evidence adduced at the four-day trial and the pleadings submitted by the parties, that the appellant had actual managerial and supervisory responsibilities at Aaron & Co., and in particular, that he supervised the market-making activity of the firm's salemen. Notwithstanding this finding, the appellant, relying on the fact that he had no official title at the firm, asserts that he had no duty to stop Jacobson and Schreiber from making the misrepresentations.

In addition, the court found (A. 807-809) that the appellant arranged sham transactions through which Aaron & Co. purchased 21,000 shares of Lawn-A-Mat control stock which were resold to the public in violation of the registration provisions of the Securities Act. The appellant

contends, however, (Br. 28-33) that because of this arrangement to purchase the control stock in sham transactions designed to feign compliance with Commission Rule 144, an exemption from registration was available.

In light of the foregoing, the district court was entitled to find a likelihood of future violations. 69/ In this regard, while scienter is not relevant to the determination that the appellant committed violations (see pages 25-40, supra), the court's findings that the appellant, in any event, did have scienter, are relevant to a consideration of the appropriateness of granting injunctive relief, 70/ and underscore the need to enjoin him from further violations. 71/

69/ Contrary to the appellant's suggestion (Br. 54) that in Commission enforcement actions, an injunction will not lie against a defendant found to have been an aider or abettor, the courts have uniformally held that such relief is appropriate. See e.g., Securities and Exchange Commission v. Universal Major Industries, supra, 546 F.2d at 1046-1047; Securities and Exchange Commission v. Management Dynamics, 515 F.2d at 811; Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 541 (C.A. 2, 1973); Securities and Exchange Commission v. North American Research & Development Corp., 424 F.2d 63 (C.A. 2, 1970); Securities and Exchange Commission v. Rega [1975-1976 Decision] CCH Fed. Sec. L. Rep. ¶ 95,222 (S.D.N.Y., 1975), appeal pending, Securities and Commission v. Coven, (C.A. 2, No. 75-6080). Securities and Exchange Commission v. Timetrust, 28 F. Supp. 34 (N.D. Cal., 1939) reversed on other grounds, 130 F.2d 214 (C.A. 9, 1942). The question was left open in Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 184 n. 12.

70/ Securities and Exchange Commission v. Universal Major Industries Corp., supra, 546 F.2d at 1048; Securities and Exchange Commission v. Spectrum, Ltd., supra, 489 F.2d at 542.

71/ The appellant claims (Br. 53) that the Commission improperly introduced into the record evidence of his participation in transactions involving unregistered, control stock of Cardiodynamics, Inc. The appellant complains that the Commission failed to state that the "case was before the NASD" and that the appellant "was not even named in that proceeding." But the Commission was not, as the appellant thus implies, urging the court to take into account a determination made in another case (see A. 581-582). Instead, the Commission, in urging that there was a need for injunctive relief against the appellant, directed the court's attention to the testimony of Philip Shapiro, a salesman at Aaron & Co., which was making a market in Cardiodynamics stock. Shapiro testified that the appellant directed him to arrange

(footnote continued)

Finally, the appellant asserts (Br. 55) that the district court erred in granting injunctive relief with respect to all securities and urges that, since his violations were limited to activities concerning one security, the injunction is "overbroad." However, the issuance of such an injunction was well within the district court's discretion, 72/ and, as the Court of Appeals for the Fifth Circuit has declared in an analogous context,

> "the manifest difficulty of the Government's inspecting, investigating, and litigating every complaint of a violation weighs heavily in favor of enforcement by injunction —after the court has found an unquestionable violation of the Act."

Mitchell v. Pidcock, 299 F.2d 281, 287 (1962) (emphasis in original). 73/

71/ (footnote continued

an agreement exactly like Aaron & Co.'s agreement with Weller in the present case, whereby Aaron & Co. would buy unregistered control Cardiodynamics stock through Morton Kaminsky, a New Jersey broker, who would receive compensation for acting as an intermediary (A. 588-598). Shapiro testified that the appellant had discussed the mechanics of the transaction, including the amount of Kaminsky's commission, with him (A. 596).

The appellant asserts (Br. 53) that the Shapiro testimony contained "inadmissable and untruthful allegations"; but at the time Shapiro's deposition was offered into evidence, counsel for the appellant stated, "I have no objection to the admission of the entire deposition of Mr. Shapiro * * *" (A. 438). Moreover, although the appellant testified after the deposition was offered into evidence, he did not attempt to rebut Shapiro's allegedly false testimony.

72/ Securities and Exchange Commission v. Manor Nursing Centers, supra, 458 F.2d at 1102-1103; Securities and Exchange Commission v. North American Research and Development Corp., 424 F.2d 632 (C.A. 2, 1970), affirming, 375 F. Supp. 465, 475; see also Federal Trade Commission v. Henry Broch & Company, 368 U.S. 360 (1962)(cease and desist order applicable to "any other buyer"); National Labor Relations Board v. Ochoa Fertilizer Corp., 368 U.S. 318 (1961)(cease and desist order applicable to "any other employer" and "any other labor organization").

73/ Moreover, where, as here, serious violations are found, the "equities" are clearly on the side of the public interest, Securities and Exchange Commission v. Culpepper, supra, 270 F.2d at 250. See Securities and

(footnote continued)

If the appellant were to return to the brokerage business, he would necessarily handle many different securities. We submit therefore, that, under the circumstances, it was not an abuse of discretion for the district court to enjoin the appellant from committing further violations of the securities laws in any security.

73/ (footnote continued)

Exchange Commission v. Graye, supra, 156 F. Supp. at 547, where Judge Kaufman stated (footnote omitted):

> "I failed to see any injury resulting to defendant by the granting of this injunction. As was stated in Securities and Exchange Commission v. Otis, D.C. Ohio, 1936, 18 F. Supp. 100, 101, affirmed Otis v. Securities and Exchange Commission, C.A. 6, 1939, 106 F.2d 579; 'If in fact defendant has no intention of again offending, it will not be injured by an injunction.' The injunction does not seek to put defendant out of business. It seeks only to restrain him from doing business while he is in violation of the S.E.C. rules. It does not seek to harm defendant, but rather to protect the public. Compliance will mean continuation."

CONCLUSION

For the foregoing reasons, the judgment of the district court should be affirmed.

Respectfully submitted,

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STATUTORY APPENDIX

Section 2(11) of the Securities Act of 1933, 15 U.S.C. 77b(11)

(11) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or[2] sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Section 4 of the Securities Act of 1933, 15 U.S.C. 77d

SEC. 4. The provisions of section 5 shall not apply to—

(1) transactions by any person other than an issuer, underwriter, or dealer.

(2) transactions by an issuer not involving any public offering.

(3) transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except—

(A) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter,

(continued)

(B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and

(C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

(4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.

Section 5(a) of the Securities Act of 1933, 15 U.S.C. 77e(a)

SEC. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Section 5(c) of the Securities Act of 1933, 15 U.S.C. 77e(c)

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a)

SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 20(b) of the Securities Act of 1933, 15 U.S.C. 77t(b)

(b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States, United States court of any Territory, or the United States District Court for the District of Columbia to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this title. Any such criminal proceeding may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such prospectus or security is received.

Rule 144 under the Securities Act of 1933, 17 CFR 230.144

§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.

PRELIMINARY NOTE

Rule 144 is designed to implement the fundamental purposes of the Act, as expressed in its preamble, "To provide full and fair disclosure of the character of the securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof * * *" The rule is designed to prohibit the creation of public markets in securities of issuers concerning which adequate current information is not available to the public. At the same time, where adequate current information concerning the issuer is available to the public, the rule permits the public sale in ordinary trading transactions of limited amounts of securities owned by persons controlling, controlled by or under common control with the issuer and by persons who have acquired restricted securities of the issuer.

Certain basic principles are essential to an understanding of the requirement of registration in the Act:

1. If any person utilizes the jurisdictional means to sell any nonexempt security to any other person, the security must be registered unless a statutory exemption can be found for the transaction.

2. In addition to the exemptions found in Section 3, four exemptions applicable to transactions in securities are contained in section 4. Three of these section 4 exemptions are clearly not available to anyone acting as an "underwriter" of securities. (The fourth, found in section 4(4), is available only to those who act as brokers under certain limited circumstances.) An understanding of the term "underwriter" is therefore important to anyone who wishes to determine whether or not an exemption from registration is available for his sale of securities.

The term underwriter is broadly defined in section 2(11) of the Act to mean any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. The interpretation of this definition has traditionally focused on the words

(continued)

"with a view to" in the phrase "purchased from an issuer with a view to * * * distribution." Thus, an investment banking firm which arranges with an issuer for the public sale of its securities is clearly an "underwriter" under that section. Individual investors who are not professionals in the securities business may also be "underwriters" within the meaning of that term as used in the Act if they act as links in a chain of transactions through which securities move from an issuer to the public. Since it is difficult to ascertain the mental state of the purchaser at the time of his acquisition, subsequent acts and circumstances have been considered to determine whether such person took with a view to distribution at the time of his acquisition. Emphasis has been placed on factors such as the length of time the person has held the securities and whether there has been an unforeseeable change in circumstances of the holder. Experience has shown, however, that reliance upon such factors as the above has not assured adequate protection of investors through the maintenance of informed trading markets and has led to uncertainty in the application of the registration provisions of the Act.

It should be noted that the statutory language of section 2(11) is in the disjunctive. Thus, it is insufficient to conclude that a person is not an underwriter solely because he did not purchase securities from an issuer with a view to their distribution. It must also be established that the person is not offering or selling for an issuer in connection with the distribution of the securities, does not participate or have a direct or indirect participation in any such undertaking, and does not participate or have a participation in the direct or indirect underwriting of such an undertaking.

In determining when a person is deemed not to be engaged in a distribution several factors must be considered.

First, the purpose and underlying policy of the Act to protect investors requires that there be adequate current information concerning the issuer, whether the resales of securities by persons result in a distribution or are effected in trading transactions. Accordingly, the availability of the rule is conditioned on the existence of adequate current public information.

Secondly, a holding period prior to resale is essential, among other reasons, to assure that those persons who buy under a claim of a section 4(2) exemption have assumed the economic risks of investment, and therefore are not acting as conduits for sale to the public of unregistered securities, directly or indirectly, on behalf of an issuer. It should be noted that there is nothing in section 2(11) which places a time limit on a person's status as an underwriter. The public has the same need for protection afforded by registration whether the securities are distributed shortly after their purchase or after a considerable length of time.

A third factor, which must be considered in determining what is deemed not to constitute a "distribution", is the impact of the particular transaction or transactions on the trading markets. Section 4(1) was intended to exempt only routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions. Therefore, a person reselling securities under section 4(1) of the Act must sell the securities in such limited quantities and in such a manner as not to disrupt the trading markets. The larger the amount of securities involved, the more likely it is that such resales may involve methods of offering and amounts of compensation usually associated with a distribution rather than routine trading transactions. Thus, solicitation of buy orders or the payment of extra compensation are not permitted by the rule.

In summary, if the sale in question is made in accordance with all of the provisions of the section as set forth below, any person who sells restricted securities shall be deemed not to be engaged in a distribution of such securities and therefore not an underwriter thereof. The rule also provides that any person who sells restricted or other securities on behalf of a person in a control relationship with the issuer shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof, if the sale is made in accordance with all the conditions of the section.

(a) *Definitions.* The following definitions shall apply for the purposes of this section.

(1) An "affiliate" of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.

(2) The term "person" when used with reference to a person for whose account securities are to be sold in reliance upon this section includes, in addition to such person, all of the following persons:

(i) Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person;

(ii) Any trust or estate in which such person or any of the persons specified in subdivision (i) of this subparagraph collectively own 10 percent or more of the total beneficial interest or of which any of such persons serve as trustee, executor or in any similar capacity; and

(iii) Any corporation or other organization (other than the issuer) in which

(continued)

such person or any of the persons specified in subdivision (i) of this subparagraph are the beneficial owners collectively of 10 percent or more of any class of equity securities or 10 percent or more of the equity interest.

(3) The term "restricted securities" means securities acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering or from the issuer in a transaction in reliance on Rule 240 under the Act or which were issued by an issuer in a transaction in reliance on Rule 240 and were acquired in a transaction or chain of transactions not involving any public offering.

(b) *Conditions to be met.* Any affiliate or other person who sells restricted securities of an issuer for his own account, or any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities, shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof within the meaning of section 2(11) of the Act if all of the conditions of this section are met.

(c) *Current public information.* There shall be available adequate current public information with respect to the issuer of the securities. Such information shall be deemed to be available only if either of the following conditions is met:

(1) *Filing of reports.* The issuer has securities registered pursuant to section 12 of the Securities Exchange Act of 1934, has been subject to the reporting requirements of section 13 of that Act for a period of at least 90 days immediately preceding the sale of the securities and has filed all the reports required to be filed thereunder during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports); or has securities registered pursuant to the Securities Act of 1933, has been subject to the reporting requirements of section 15(d) of the Securities Exchange Act of 1934 for a period of at least 90 days immediately preceding the sale of the securities and has filed all the reports required to be filed thereunder during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports). The person for whose account the securities are to be sold shall be entitled to rely upon a statement in whichever is the most recent report, quarterly or annual, required to be filed and filed by the issuer that such issuer has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the issuer was required to file such reports) and has been subject to such filing requirements for the past 90 days, unless he knows or has reason to believe that the issuer has not complied with such requirements. Such person shall also be entitled to rely upon a written statement from the issuer that it has complied with such reporting requirements unless he knows or has reasons to believe that the issuer has not complied with such requirements.

(2) *Other public information.* If the issuer is not subject to section 13 or 15(d) of the Securities Exchange Act of 1934, there is publicly available the information concerning the issuer specified in subdivision (i) to (xiv), inclusive, and subdivision (xvi) of paragraph (a)(4) of § 240.15c2-11 of this chapter or, if the issuer is an insurance company, the information specified in section 12(g)(2)(G)(i) of that Act.

(d) *Holding period for restricted securities.* If the securities sold are restricted securities, the following provisions apply:

(1) *General rule.* The person for whose account the securities are sold shall have been the beneficial owner of the securities for a period of at least 2 years prior to the sale and, if the securities were purchased, the full purchase price or other consideration shall have been paid or given at least 2 years prior to the sale.

(2) *Promissory notes, other obligations or installment contracts.* Giving the person from whom the securities were purchased a promissory note or other obligation to pay the purchase price, or entering into an installment purchase contract with such person, shall not be deemed full payment of the purchase price unless the promissory note, obligation or contract—

(i) Provides for full recourse against the purchaser of the securities;

(ii) Is secured by collateral, other than the securities purchased, having a fair market value at least equal to the purchase price of the securities purchased; and

(iii) Shall have been discharged by payment in full prior to the sale of the securities.

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(3) *Short sales, puts or other options to sell securities.* In computing the 2-year holding period the following periods shall be excluded:

(i) If the securities sold are equity securities, there shall be excluded any period during which the person for whose account they are sold had a short position in, or any put or other option to dispose of, any equity securities of the same class or any securities convertible into securities of such class; and

(ii) If the securities sold are nonconvertible debt securities, there shall be excluded any period during which the person for whose account they are sold had a short position in, or any put or other option to dispose of, any nonconvertible debt securities of the same issuer.

(4) *Determination of holding period.* The following provisions shall apply for the purpose of determining the period securities have been held:

(i) *Stock dividends, splits and recapitalizations.* Securities acquired from the issuer as a dividend or pursuant to a stock split, reverse split or recapitalization shall be deemed to have been acquired at the same time as the securities on which the dividend or, if more than one, the initial dividend was paid, the securities involved in the split or reverse split, or the securities surrendered in connection with the recapitalization;

(ii) *Conversions.* If the securities sold were acquired from the issuer for a consideration consisting solely of other securities of the same issuer surrendered for conversion, the securities so acquired shall be deemed to have been acquired at the same time as the securities surrendered for conversion;

(iii) *Contingent issuance of securities.* Securities acquired as a contingent payment of the purchase price of an equity interest in a business, or the assets of a business, sold to the issuer or an affiliate of the issuer shall be deemed to have been acquired at the time of such sale if the issuer or affiliate was then committed to issue the securities subject only to conditions other than the payment of further consideration for such securities. An agreement entered into in connection with any such purchase to remain in the employment of, or not to compete with, the issuer or affiliate or the rendering of services pursuant to such agreement shall not be deemed to be the payment of further consideration for such securities.

(iv) *Pledged securities.* Securities which are bona fide pledged by any person other than the issuer when sold by the pledgee, or by a purchaser, after a default in the obligation secured by the pledge, shall be deemed to have been acquired when they were acquired by the pledgor, except that if the securities were pledged without recourse they shall be deemed to have been acquired by the pledgee at the time of the pledge or by the purchaser at the time of purchase.

NOTE: Securities sold by the pledgee shall be aggregated with those sold by the pledgor, as provided in paragraph (e)(3)(ii) of this section.

(v) *Gifts of securities.* Securities acquired from any person, other than the issuer, by gift shall be deemed to have been acquired by the donee when they were acquired by the donor;

NOTE: Securities sold by the donee shall be aggregated with those sold by the donor, as provided in paragraph (e)(3)(iii) of this section.

(vi) *Trusts.* Securities acquired from the settlor of a trust by the trust or acquired from the trust by the beneficiaries thereof shall be deemed to have been acquired when they were acquired by the settlor;

NOTE: Securities sold by the trust shall be aggregated with those sold by the settlor of the trust, as provided in paragraph (e)(3)(iv) of this section.

(vii) *Estates.* Securities held by the estate of a deceased person or acquired from such an estate by the beneficiaries thereof shall be deemed to have been acquired when they were acquired by the deceased person, except that no holding period is required if the estate is not an affiliate of the issuer or if the securities are sold by a beneficiary of the estate who is not such an affiliate.

NOTES: (a) Securities sold by the estate shall be aggregated with those sold by the deceased person, as provided in paragraph (e)(3)(v) of this section, if the estate is an affiliate of the issuer.

(b) While there is no holding period or amount limitation for estates and beneficiaries thereof which are not affiliates of the insurer, paragraphs (c), (f), (g), (h), and (i) of the section apply to securities sold by such persons in reliance upon the section.

(e) *Limitation on Amount of Securities Sold.* Except as hereinafter provided, the amount of securities which may be

(continued)

sold in reliance upon this rule shall be determined as follows:

(1) *Sales by Affiliates.* If restricted or other securities are sold for the account of an affiliate of the issuer, the amount of securities sold, together with all sales of restricted and other securities of the same class for the account of such person within the preceding six months, shall not exceed the following:

(i) If the securities are admitted to trading on a national securities exchange or are quoted on the automated quotation system of a registered securities association as well as traded on a national securities exchange, the lesser of (*a*) one percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer, or (*b*) either (*1*) the average weekly reported volume of trading in such securities on all securities exchanges and reported through such automated quotation system during the four calendar weeks preceding the filing of notice required by Paragraph (h), or if no such notice is required the receipt of the order to execute the transaction by the broker, or (2) if transactions in such securities are reported in the consolidated transaction reporting system contemplated by Rule 17a–15 under the Securities Exchange Act of 1934, the average weekly reported volume of such securities in that system during same period specified in (a) above; or

(ii) If the securities are not traded on a national securities exchange, 1 percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer.

(2) *Sales by persons other than affiliates.* The amount of restricted securities sold for the account of any person other than an affiliate of the issuer, together with all other sales of restricted securities of the same class for the account of such person within the preceding 6 months, shall not exceed the amount specified in subparagraph (1) (i) or (ii) of this paragraph, whichever is applicable.

(3) *Determination of amount.* For the purpose of determining the amount of securities specified in paragraphs (e) (1) and (2) of this section, the following provisions shall apply.

(i) Where both convertible securities and securities of the class into which they are convertible are sold, the amount of convertible securities sold shall be deemed to be the amount of securities of the class into which they are convertible for the purpose of determining the aggregate amount of securities of both classes sold;

(ii) The amount of securities sold for the account of a pledgee thereof, or for the account of a purchaser of the pledged securities, during any period of 6 months within 2 years after a default in the obligation secured by the pledge and the amount of securities sold during the same 6-month period for the account of the pledgor shall not exceed, in the aggregate, the amount specified in subparagraph (1) or (2) of this paragraph whichever is applicable;

(iii) The amount of securities sold for the account of a donee thereof during any period of 6 months within 2 years after the donation, and the amount of securities sold during the same 6-month period for the account of the donor, shall not exceed, in the aggregate, the amount specified in subparagraph (1) or (2) of this paragraph, whichever is applicable;

(iv) Where securities were acquired by a trust from the settlor of the trust, the amount of such securities sold for the account of the trust during any period of 6 months within 2 years after the acquisition of the securities by the trust, and the amount of securities sold during the same 6-month period for the account of the settlor, shall not exceed, in the aggregate, the amount specified in subparagraph (1) or (2) of this paragraph, whichever is applicable;

(v) The amount of securities sold for the account of the estate of a deceased person, or for the account of a beneficiary of such estate, during any period of 6 months and the amount of securities sold during the same period for the account of the deceased person prior to his death shall not exceed, in the aggregate, the amount specified in subparagraph (1) or (2) of this paragraph, whichever is applicable: *Provided,* That no limitation on amount shall apply if the estate or beneficiary thereof is not an affiliate of the issuer;

(vi) When two or more affiliates or other persons agree to act in concert for the purpose of selling securities of an issuer, all securities of the same class sold for the account of all such persons during any period of 6 months shall be aggregated for the purpose of determining the limitation on the amount of securities sold; and

(continued)

(vii) Securities sold pursuant to an effective registration statement under the Act or pursuant to an exemption provided by Regulation A under the Act or in a transaction exempt pursuant to section 4 of the Act and not involving any public offering need not be included in determining the amount of securities sold in reliance upon this rule.

(f) *Manner of sale.* The securities shall be sold in "brokers' transactions" within the meaning of section 4(4) of the Act and the person selling the securities shall not (1) solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transactions, or (2) make any payment in connection with the offering or sale of the securities to any person other than the broker who executes the order to sell the securities.

(g) *Brokers' transactions.* The term "brokers' transactions" in section 4(4) of the Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker—

(1) Does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold; and receives no more than the usual and customary broker's commission;

(2) Neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; provided, that the foregoing shall not preclude (i) inquiries by the broker of other brokers or dealers who have indicated an interest in the securities within the preceding 60 days, (ii) inquiries by the broker of his customers who have indicated an unsolicited bona fide interest in the securities within the preceding 10 business days; or (iii) the publication by the broker of bid and ask quotations for the security in an inter-dealer quotation system provided that such quotations are incident to the maintenance of a bona fide inter-dealer market for the security for the broker's own account and that the broker has published bona fide bid and ask quotations for the security in an inter-dealer quotation system on each of at least twelve days within the preceding thirty calendar days with no more than four business days in succession without such two-way quotations;

NOTE TO PARAGRAPH (g)(2)(ii): The broker should obtain and retain in his files written evidence of indications of bona fide unsolicited interest by his customers in the securities at the time such indications are received.

(3) After reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer. Without limiting the foregoing, the broker shall be deemed to be aware of any facts or statements contained in the notice required by paragraph (h) of this section.

NOTES: (i) The broker, for his own protection, should obtain and retain in his files a copy of the notice required by paragraph (h) of this section.

(ii) The reasonable inquiry required by paragraph (g)(3) of this section should include, but not necessarily be limited to, inquiry as to the following matters:

(*a*) The length of time the securities have been held by the person for whose account they are to be sold. If practicable, the inquiry should include physical inspection of the securities;

(*b*) The nature of the transaction in which the securities were acquired by such person;

(*c*) The amount of securities of the same class sold during the past 6 months by all persons whose sales are required to be taken into consideration pursuant to paragraph (e) of this section;

(*d*) Whether such person intends to sell additional securities of the same class through any other means;

(*e*) Whether such person has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;

(*f*) Whether such person has made any payment to any other person in connection with the proposed sale of the securities; and

(*g*) The number of shares or other units of the class outstanding, or the relevant trading volume.

(h) *Notice of proposed sale.* Concurrently with the placing with a broker of an order to execute a sale of any securities in reliance upon this rule, there shall be transmitted to the Commission, at its principal office in Washington, D.C., for filing three copies of a notice on Form 144 which shall be signed by the person for whose account the securities are to be sold; and, if such securities are admitted to trading on any national exchange, one copy of such notice shall be transmitted to the principal national securities exchange on which such securities are so admitted: Provided, That such a notice need not be filed if the amount of securities to be sold during any period of six months does not exceed

(continued)

500 shares or other units and the aggregate sale price thereof does not exceed $10,000. If all of the securities for which a notice is filed are not sold within 90 days after the filing of such notice, an amended notice shall be transmitted to the Commission concurrently with the commencement of any further sales of such securities; and, if such securities are admitted to trading on any national exchange, one copy of such amended notice shall be transmitted to the principal national securities exchange on which such securities are so admitted. Neither the filing of such notice nor the failure of the Commission to comment thereon shall be deemed to preclude the Commission from taking any action it deems necessary or appropriate with respect to the sale of the securities referred to in such notice.

(i) *Bona fide intention to sell.* The person filing the notice required by paragraph (h) of this section shall have a bona fide intention to sell the securities referred to therein within a reasonable time after the filing of such notice.

[37 FR 596, Jan. 14, 1972, as amended at 37 FR 20558, Sept. 30, 1972; 39 FR 6071, Feb. 19, 1974; 39 FR 8914, Mar. 7, 1974; 40 FR 6488, Feb. 12, 1975; 41 FR 24702, June 18, 1976]

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b)

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d)

(d) Wherever it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this title or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.

Rule 10b-5 under the Securities Exchange Act of 1934, 17 CFR 240.10b-5

§ 240.10b–5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j) [13 F.R. 8183, Dec. 22, 1948, as amended at 16 F.R. 7928, Aug. 11, 1951]