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I. INTRODUCTION

One of the most interesting as well as controversial areas of the securities laws has been the growth of implied liabilities under section 10(b) of the Securities Exchange Act of 1934[1] and Rule 10b-5[2] promulgated thereunder.[3] Any attempt to codify the securities laws would probably include an attempt to codify this entire 10b-5 area.[4]

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1. Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (1964) [hereinafter cited as 1934 Act] provides in part:

"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."

2. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1969) provides:

"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,

(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."

3. Today, it is settled in virtually every circuit that an implied private remedy may be granted for damages resulting from the violation of § 10(b), 15 U.S.C. § 78j(b) (1964), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1969). Boone v. Baugh, 308 F.2d 711 (8th Cir. 1962); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962); Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

In addition, dicta in other circuits and acceptance of this theory by federal district courts indicates approval of the doctrine of implied civil liability pursuant to Rule 10b-5, 17 C.F.R. § 240.10b-5 (1969). *See, e.g.*, Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963); Nash v. J. Arthur Warner & Co., 137 F. Supp. 615 (D. Mass. 1955).

4. *See generally Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793 (1967), and more specifically the quotations in the text accompanying notes 7-12 *infra*.

Once the codifiers move into this area, however, there is a strong likelihood that codification will result in reform and revision, and the present scope as well as the future growth and development of "federal corporation law" under Rule 10b-5 will be profoundly altered.[5] Thus it would seem that before an attempt is made to codify the body of law that has evolved from Rule 10b-5, the following questions should be considered: Is the way the law in this area has developed injurious to the public interest? Has the legal development under Rule 10b-5 adversely or beneficially affected the securities markets and the public interest? In short, is there any need for codification, reform, or revision in the 10b-5 area?[6]

II. THE REAL AIM OF THE CODIFIERS

At the Conference on Codification of the Federal Securities Laws held in Chicago in November, 1966, speaker after speaker disclosed a certain displeasure with existing law in the 10b-5 area and hinted at or even openly recommended some sort of change. George M. Duff, Jr. stated quite candidly:

> In conclusion, although there are many inconsistencies in the various sections of the Securities Acts relating to civil liabilities, Rule 10b-5 as interpreted by the courts emphasizes these inconsistencies and is in most need of careful reexamination by the Commission or legislative review. I hope that we will be not like Nero playing the lyre while Rome burns. If we wait too long, we won't have to codify Section 5 of the 1933 Act. Who needs Section 5 if you have Rule 10b-5 around, or Section 14 or Section 16 of the Securities Exchange Act? Rule 10b-5 is a much better remedy. At least parts of Sections 9 and 15 of the 1934 Act will be of no value and there will no longer be any need for Section 17(a) of the '33 Act.
>
> And then after Rule 10b-5 preempts the securities field we will be left with codifying Rule 10b-5, which is perhaps where we should begin at the present time.[7]

David S. Henkel delivered an illuminating paper on the different substantive provisions and procedural avenues available to plaintiffs contemplating suit under the Securities Act of 1933 and the Securities Exchange Act of 1934.[8] The main thrust of Mr. Henkel's article was that the specific safeguards enacted by Congress to protect defendants

5. *Id.*

6. *See* Loss, *History of S.E.C. Legislative Programs and Suggestions for a Code, Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 804-05 (1967) (panel discussion by Louis Loss, Richard H. Paul, and A. Fleischer, Jr.).

7. Henkel, *Codification—Civil Liability Under the Federal Securities Laws, Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 866, 886-87 (1967) (remarks of George M. Duff, Jr.).

8. *Id.* at 866-78.

against civil liabilities have been emasculated by the judicial implication of private rights under section 10(b) and Rule 10b-5.

> [S]pecific safeguards relating to burden of proof, defenses, statutes of limitations and other conditions to recovery which were thought appropriate by the Congress when it enacted the specific civil liability provisions are entirely avoided. The result is that the issuer, the underwriter, the broker-dealer and others have been denied the protection of the safeguards which many people thought existed and have been placed with increasing frequency in the position of having to defend actions which, only a short time ago, were not even contemplated by persons expert in the securities law field.
>
> It is difficult for me to believe that the draftsmen of the federal securities laws would have taken the trouble to prescribe the limitations and defenses applicable to actions brought under the various sections which specifically provide for civil liabilities if, at the same time, they had contemplated that similar actions without such limitations and defenses could be brought under various other sections which do not specifically provide for civil liabilities. In any event, I feel that it would be in the public interest to strive for some semblance of order and consistency in this area. In my view 10(b)5 should be a primary target.[9]

Professor Louis Loss, the Conference's keynote speaker and the writer of the leading treatise in the securities law field, expressed his views on Rule 10b-5 in the following fashion:

> Still further when one talks about fraud, what sense does it make, really, to have 17 and 15(c) and 10(b)? Why not a single, central, well-thought-through fraud provision? Why three except that they grew up in a hodgepodge way?[10]

James C. Sargent seemed to echo Professor Loss's view:

> It is odd to me that the Rule 10b-5 situation has caused not only an eclipsing of Section 11 and Section 12(2), but practically the elimination of the short statute of limitations contained in Section 13 of the '33 Act. That is a kind of curious result.
>
> Rule 10b-5 gives the plaintiff a longer statute of limitations within which to live which limitations, as you know, tend to be the nearest comparable statute of limitations of the state where the cause of action was commenced. Where an investor finds himself in a position where he needs the protection of the '33 Act, but he is too late to enforce his rights, he moves over to the '34 Act and he is protected by the longer statute of limitations. At least, so the courts seem to think.[11]

And Harold W. Marsh, Jr. stated quite openly:

> [W]e admit having a love feast here—but I need only mention what we will do with 10b-5 to tell you that whatever this code says there are going to be people vehemently opposed to it . . . .[12]

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9. *Id.* at 871.

10. Loss, *supra* note 6, at 796.

11. *Id.* at 801 (remarks of James C. Sargent).

12. Cohen, *Toward Coordination of 1933 and 1934 Act Disclosure Requirements, Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 810, 848 (1967) (remarks of Harold W. Marsh, Jr.).

A careful analysis of the above statements cannot help but lead one to speculate whether codification or even reform is the real aim of the codifiers. Perhaps it would be more accurate to conclude that their real motive is substantially to circumscribe the existing scope of Rule 10b-5 and severely limit any possibilities for its future growth and expansion.

III. THE PRESENT ROLE OF RULE 10B-5

If it is decided that the real aim of the codifiers is to inhibit the growth of implied liabilities under Rule 10b-5, it becomes vital to assess the present status of this Rule. Has the growth and development of implied liabilities under this Rule affected the public interest and the securities markets positively or negatively? Would the reversal of development in the 10b-5 area envisioned by the codifiers offer more or less protection to an American public which has a multi-billion dollar investment in the American securities markets?

There are a number of important areas where the only practical protection against fraudulent practices in securities trading is provided by section 10(b) and Rule 10b-5. For example, persons who purchase securities at the same time that a registered public offering is made, but make such purchase not from the public offering but from the market that was influenced by a misleading registration statement, have section 10(b) and Rule 10b-5 as their only practical remedy.[13] Also, persons who purchase securities pursuant to a transaction exempt from the registration provisions of the 1933 Act, such as an exchange by an issuer with its own stockholders, a private placement, or an intrastate offering, must rely on section 10(b) and Rule 10b-5 as their only practical protection against fraud.[14] In addition, persons who buy government securities, including municipal bonds, pursuant to the exemption supplied by section 3(a)(2) of the 1933 Act must look to section 10(b) and Rule 10b-5 for their sole cause of action against fraudulent practitioners.[15]

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13. Section 17 of the Securities Act of 1933, 15 U.S.C. § 77q (1969), has not been sufficiently utilized to make it a reliable basis for a private action. Section 12(z), 15 U.S.C. § 771(2) (1964), limits plaintiff to a suit against the person who sold him the securities; in an open-market purchase the identity of the seller cannot always be determined.

14. In addition to the problems outlined in note 13 *supra*, a desirable defendant in these types of situations is often a different person than the one who sold the securities to the defrauded purchaser. In these circumstances § 12(2), 15 U.S.C. § 771(2) (1964), cannot be utilized.

15. *See* Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960). In all of these situations plaintiffs may sue under state law, but state law has not proven

The proxy area offers an excellent illustration of the importance of Rule 10b-5 in the overall scheme of complete investor protection. In a merger situation, the SEC has promulgated itemized rules of disclosure,[16] including a broad fraud rule,[17] and the Supreme Court in the *Borak* case added a powerful implied private right of action.[18] The SEC's proxy rules, however, are inapplicable to all companies not registered under section 12 of the 1934 Act,[19] and even for section 12 companies, if the fraud is not in the proxy statement, but solely in some other phase of the transaction, the *Borak* right is nonexistent.[20] In these situations the only practical remedy a defrauded investor has is under section 10(b) and Rule 10b-5.

Because of the limitations of section 15 of the 1934 Act, Rule 15c1-2, promulgated by the SEC to deal with fraud by brokers,[21] can only prohibit brokers' frauds in the over-the-counter securities markets.[22] It is left for Rule 10b-5 to offer a private remedy to persons defrauded by brokers through stock exchange transactions. Similarly, Rule 10b-5 can be a valuable tool in discouraging market manipulations. Section 9 of the 1934 Act, the specific antimanipulative provision of the securities acts, is so burdened with difficult, if not impossible, requirements of proving causation, it is practically useless as a basis for private remedies in the manipulation area.[23] Finally, Rule 10b-5 is becoming important in the area of misleading corporate publicity. Section 18 of the 1934 Act covers only misleading reports filed with the SEC or the stock exchanges; its application is further restricted by proof requirements and available defenses which make investor suits almost meaningless exercises.[24] Rule 10b-5, on the other hand, permits suits against persons publicly disseminating any fraudulent corporate reports and eliminates the impossible hurdles imposed by section 18.[25]

In addition to its role as a backstop, or what Professor William

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to be an effective tool in combatting securities fraud in what is primarily a national, interstate economy.

16. 17 C.F.R. § 240.14a-11 (Schedule 14A) (1964).
17. Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a) (1969).
18. J.I. Case Co. v. Borak, 377 U.S. 426 (1964).
19. 1934 Act § 14, 15 U.S.C. § 78n (1964).
20. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a) (1969).
21. Rule 15(c)1-2, 17 C.F.R. § 240.15c1-2 (1969).
22. 1934 Act § 15, 15 U.S.C. § 78o (1964).
23. *Id.* § 9, 15 U.S.C. § 78i (1964).
24. *Id.* § 18, 15 U.S.C. § 78r (1964).
25. *See* Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

L. Cary has termed a "roving center in the anti-fraud field,"[26] the broad language of Rule 10b-5 has provided investor protection in what are today evolving or frontier areas of the securities laws. The vital concept of eliminating trading on inside information which matured with the SEC's decision in *Cady, Roberts & Co.*[27] and reached full flower in the *Texas Gulf Sulphur* case,[28] is bottomed on section 10(b) and Rule 10b-5. The problem of misleading corporate publicity and fraudulent press releases can probably be dealt with effectively only under the broad provisions of section 10(b) and Rule 10b-5. Indeed, for a time the SEC considered adopting rules in the publicity area, but abandoned this idea partly because of the difficulty of formulating standards and partly because of the availability of the general anti-fraud provisions.[29] The whole area of intra-corporate fiduciary duties—the duties of management to stockholders, of majority stockholders to minority stockholders, and of "inside" directors to "outside" directors—is coming under the increasing scrutiny of the federal courts asserting jurisdiction on the basis of section 10(b) and Rule 10b-5.[30] The stockholders' derivative suit based upon section 10(b) and Rule 10b-5—with its nationwide service of process and venue, its avoidance of state security for costs and short statute of limitation requirements, and its use of the modern discovery techniques provided by the Federal Rules of Civil Procedure—has proved a vital aid to SEC enforcement in an era of reduced government budgets and high SEC staff turnover.[31] In sum, Rule 10b-5 has encouraged the courts to free themselves from the technical restrictions of common law fraud developed by a society concerned largely with chattels and tangible products. Rule 10b-5 has made complete nondisclosure equivalent to an affirmative misrepresentation,[32] has eliminated scienter,[33] and has substantially diluted privity.[34] It is, therefore, difficult to conclude that

26. Cary, *Summation: Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 909 (1967).

27. 40 S.E.C. 907 (1961).

28. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

29. *See* A. BROMBERG, SECURITIES LAWS: FRAUD—SEC RULE 10B-5, § 7.2(3), at 152 n.43 (1969).

30. *See* McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961); Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963).

31. *See* Lowenfels, *Rule 10b-5 and the Stockholder's Derivative Action*, 18 VAND. L. REV. 893 (1965).

32. *See* A. BROMBERG, *supra* note 29, § 8.2, at 197 n.6.

33. *Id.* § 8.4, at 203 n.24.

34. *Id.* § 8.5, at 205 n.28.

these developments have not resulted in much greater protection for the investing public.

IV. CONCLUSION

The results of what the federal courts have done with Rule 10b-5 are truly astounding. An obscure rule promulgated by an administrative agency to combat fraud has become the basis of much of our contemporary securities law.[35] Certain academicians might be offended by the lack of order or symmetry in such a development; certain corporate interests might sense a threat to their established powers or properties; but by and large the growth and development under Rule 10b-5 have served the public interest. The American securities markets are among the most honest in the world, and Rule 10b-5 has played no small role in establishing this integrity. What interests would be served by codification in the 10b-5 area? Congress codified an insider trading provision under section 16(b) of the 1934 Act, and its implementation has not been highly successful.[36] Congress attempted to insert provisions prohibiting "tipping" into section 16(b), but dropped the idea "presumably because of the difficulty in administering it."[37] The SEC attempted to draft certain rules governing corporate publicity, but abandoned this venture because it was too difficult.[38] These are but a sampling of the areas to which Rule 10b-5 has been applied.

Congress enacted section 10(b) in broad and sweeping terms, delegating to the SEC the job of promulgating specific rules to outlaw securities fraud.[39] In accordance with this legislative mandate, the Commission has adopted a number of rules during the last 36 years, but in reality it has been left for the federal courts, using Rule 10b-5 as the springboard, to implement the purposes underlying section 10(b) in an effective manner. Fraud has many faces, many forms, and many nuances. Placed in the context of highly sophisticated securities markets, fraud can be regulated only by the judiciary, pragmatically, on a case by case basis. As one leading authority has stated: "[R]igid

35. For an amusing description of the origin of Rule 10b-5, see 22 BUS. LAW. 793, 921-23 (1967) (remarks of Milton Freeman).

36. Until recently the federal courts felt compelled to apply § 16(b), 15 U.S.C. § 78p(b) (1964), in a rigid, mechanistic fashion which often engendered curious, if not unjust, results. *See* Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 CORNELL L. REV. 45 (1968).

37. A. BROMBERG, *supra* note 29, § 7.5(2), at 190.7 n.218.

38. *See* A. BROMBERG, *supra* note 29.

39. 1934 Act § 10(b), 15 U.S.C. § 78j(b) (1964).

rules are not adaptable to the wide variety of securities transactions that may occur in an economy as highly developed as ours."[40] Codification may be appropriate in certain areas of the securities laws, but to codify fraud will be to inhibit, not to expand, protection for the investing public.

40. A. BROMBERG, *supra* note 29, § 8.9, at 223.